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Office of Tax Simplification

By email

Dear Sirs

Submission from Berwin Leighton Paisner to the Office of Tax Simplification

We very much welcome the establishment of the Office of Tax Simplification (OTS) and the Government's commitment to making the UK tax system simpler and more competitive.

As the City law firm with the largest and broadest based tax practice (including a sizable private client group), we are very familiar with the challenges posed by the UK tax code. Our experience of advising businesses and individuals on tax issues puts us in an informed position on the issue of tax simplification.

With this in mind, we would like to make a number of comments on the review of reliefs, allowances and exemptions, which we hope will assist the OTS as it prepares its preliminary report.

1 PROVISIONAL REVIEW CRITERIA

1.1 We will not produce a genuinely competitive tax system by merely repealing redundant or little used reliefs, and so we were pleased to note that the OTS will also make recommendations for reliefs to be modified, streamlined or delivered in a different way.

1.2 Simplicity itself should not be seen as the end goal, but only as the means to achieving a more competitive tax system to signal that Britain is "open for business". Whilst we strongly support the aim of making our tax code shorter, simpler and less of a barrier to enterprise, it will be counter-productive to create simplicity at the expense of reliefs that should encourage investment and growth if they are implemented properly. The fact that a relief is rarely used is not, therefore, necessarily a good reason for repealing it. The policy rationale for the relief may remain valid but the relief is underused because it is too complicated and/or not valuable enough.

1.3 Any proposed reform of a relief must, therefore, be tested against policy, and we understand that consideration of policy is within the scope of the OTS's remit. To that end, we suggest that the consequences of the following five options are analysed in relation to each sample relief that the OTS reviews (aside from those that are completely redundant):

(a) repealing the relief entirely;

(b) leaving the relief unchanged;

(c) retaining the relief in its current form but making it more valuable;

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(d) modifying the relief; and

(e) modifying the relief and making it more valuable.

1.4 We of course recognise that making reliefs more valuable will be difficult in the current economic climate, but we would strongly urge the OTS to recommend that the Government takes a broad long term view. Encouraging business with a competitive tax system should yield a much greater tax take in the future.

1.5 In addition, we believe that there is a considerable empirical evidence to suggest that lower tax rates and reduced reliefs raise more tax revenue for government over the medium term. Therefore, removal of reliefs also needs to be considered against the backdrop of applicable tax rates to properly encourage economic activity rather than stifle it.

2 LIST OF SPECIFIC RELIEFS

2.1 We were pleased to see that the OTS has taken a broad view of what constitutes a relief. However, in many cases we believe that a relief can only properly be reviewed as part of a review of the relevant tax as a whole. Some reliefs could be removed or simplified only if fundamental changes are made to the relevant tax charge. Where appropriate, therefore, our comments cover the relevant charging provisions as well as the relief.

2.2 We have chosen to comment on those areas:

(a) which have caused significant practical difficulty on transactions and other matters on which we have advised;

(b) about which our clients have expressed particular concerns; and/or

(c) where we believe that there are significant policy issues that should be taken into account by the OTS.

2.3 Controlled Foreign Companies (CFCs)

2.3.1 The CFC regime is, of course, subject to ongoing consultation, and we look forward to seeing the details of the proposals for interim improvements to the regime, which are due to be published shortly. We have already made more detailed representations on the proposals for CFC reform, which we would be happy to share with the OTS.

2.3.2 The UK's CFC regime has achieved unenviable notoriety as a barrier to multinationals doing business in the UK. The purported implementation of *Cadbury Schweppes* in the current legislation is a classic example of UK tax legislation being unnecessarily overcomplicated. We accept the need to protect the UK exchequer from aggressive tax avoidance involving low tax jurisdictions, but the CFC regime is a good example of a legitimate policy objective of minimising avoidance becoming a counter-productive obsession. In its single minded desire to stamp out avoidance the previous government lost sight of the damage that it was doing to legitimate business. The complex mechanism contained in section 751A ICTA 1988, which attempted to navigate around the *Cadbury Schweppes* decision rather than incorporate it at its heart, created even more uncertainty for business. Arguably the loss to the economy of businesses moving overseas or not locating in the UK because of the

increasing uncertainty in the CFC regime has cost far more tax than might have been saved by those rules.

2.3.3 It is critical that the same mistake is not repeated with the new CFC regime. We would therefore recommend three principal changes to the CFC regime that would redress the balance between tackling avoidance and damaging legitimate business:

(a) small and medium sized enterprises should be taken out of the CFC regime completely, as they are for the transfer pricing regime, or given the benefit of a very wide ranging exemption;

(b) any tests relating to commercial justification, economic substance or motive should follow the test formulated in *Cadbury Schweppes* as closely as possible and the same test should apply in relation to CFCs located in all jurisdictions, not just within the EU; and

(c) there should be no carve outs from any commercial justification, economic substance or motive test for particular types of transaction or income. Any arrangements that are not wholly artificial should not be subject to the CFC regime.

2.3.4 We understand that HMRC does not necessarily accept that *Cadbury Schweppes* has the same force and effect that most tax professionals believe it has. However, this attitude is symptomatic of the fundamental flaw in the approach to tax policy making that HM Treasury and HMRC have historically taken, particularly in relation to EU law. Rather than working with business to implement *Cadbury Schweppes* in a way that created clarity, certainty and simplicity, their efforts to interpret and implement the decision as narrowly as possible resulted in even more unnecessary complexity and uncertainty. We hope that the reform of the CFC rules will reverse this mistake.

2.4 Capital allowances

2.4.1 Given that the number and burden of "green" taxes is only likely to increase, we believe that it is vitally important that environmental incentives are retained and, where possible, their value increased. Many of these incentives are delivered through the capital allowances system, and in our view this should continue.

2.4.2 We recognise that this is not necessarily compatible with a goal of simplifying the tax system because it involves retaining, and possibly increasing, the number of reliefs. However, we do not think that any environmental policy that tries to change behaviour with taxes but not incentives will achieve its aims, and neither will it encourage growth. The CRC Energy Efficiency Scheme has effectively been turned into a tax because HM Treasury is going to retain the money raised rather than return it to "good" businesses; it is therefore even more important that business is given proper environmental incentives.

2.4.3 There is, therefore, a need to retain some degree of complexity in this area. To ensure that this does not stifle take-up of the incentives, they need to be sufficiently valuable.

2.4.4 Also, improving allowances that encourage regeneration (for example, the business premises regeneration allowance) would support the Government's aim of creating more

private sector jobs in areas that have historically been too dependent on the public sector for employment.

2.5 Stamp Duty Land Tax (SDLT)

2.5.1 The OTS has identified seventy reliefs from SDLT, although there are three notable absences, namely:

(a) the "SLP test" in the partnership provisions contained in Schedule 15 of Finance Act 2003 (which effectively reduces the SDLT charge on transfers to and from partnerships to the extent that a partner is a party to the transaction); and

(b) the two "white lists" of transactions that HMRC considers are not caught by the general anti-avoidance rule in section 75A Finance Act 2003 or the group relief anti-avoidance rule in paragraph 4ZA of Schedule 7 Finance Act 2003.

2.5.2 SDLT is another unfortunate example of the imbalance in the tax system between preventing avoidance and interfering with genuine commercial transactions. SDLT is itself an anti-avoidance measure, introduced to combat the avoidance of stamp duty by replacing a duty payable on the stamping of documents with a land transaction tax. Since its introduction in 2003 the primary SDLT legislation has nearly doubled in length. Numerous anti-avoidance measures have been added, which have left a complex maze of obscure and poorly drafted provisions that must be navigated when carrying out any transaction beyond the most straightforward property sale.

Partnership rules

2.5.3 The SDLT partnership provisions in Schedule 15 of Finance Act 2003 have achieved notoriety amongst real estate tax practitioners for their complexity and the uncertainty that they have caused. There are two particular issues which illustrate this.

(a) First, for several years there was uncertainty about how the partnership rules interacted with group relief from SDLT. In 2007 Crispin Taylor, the former assistant director for SDLT policy at HMRC, made a comment that, broadly, group relief was not available when land was transferred out of a partnership. Although the legislation is not entirely clear, most practitioners disagreed with his analysis. However, the uncertainty created by Mr Taylor's comments obviously caused significant problems. Last year HMRC finally confirmed that group relief could be available for transfers out of partnership. The fact that HMRC could not be sure how the rules were meant to apply to relatively straightforward situations involving group companies and partnerships demonstrates the problems that the SDLT legislation can cause.

(b) Second, there is a restriction on partners withdrawing money from a partnership within three years of land being acquired by the partnership[1]. This was originally intended as an anti-avoidance measure but is now redundant. When the partnership rules were introduced SDLT was charged on consideration paid for

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1 Paragraph 17A Schedule 15 Finance Act 2003

transfers in and out of partnerships as well as the market value of the property. This restriction on withdrawing money was intended to prevent taxpayers avoiding an SDLT charge on the cash consideration. However, the rules have since been amended and SDLT is now only charged on the market value of the property, not any consideration actually paid. Therefore, although the anti-avoidance provision remains, the charge it was designed to protect has been abolished. This is not just a theoretical point. Breaching this restriction could lead to a significant SDLT charge; on one joint venture transaction we had to draft a complex set of provisions to prevent the parties triggering this now redundant charge accidentally.

General anti-avoidance rule

2.5.4 Section 75A Finance Act 2003 is a general anti-avoidance rule, which was introduced in 2006. It effectively codifies a reversal of *IRC v Duke of Westminster* in respect of SDLT because it does not contain any motive or purpose test. In certain situations it simply recalculates the SDLT payable in respect of a series of transactions to the maximum amount that could have been paid, even if all of those transactions are legitimate, commercial ones. Obviously such a wide provision has caused significant practical problems, something that HMRC appeared to recognise when it published a white list of transactions which it does not consider are caught. Whilst this white list does provide some relief from an anti-avoidance provision which has been drafted far too widely, the provision itself continues to cause huge problems on genuine commercial transactions because of a lack of motive test, and matters were made even worse by the amendment relating to partnerships that was announced in this year's March Budget. There are many situations in which section 75A cannot possibly be intended to apply, but where on its face it does. The "relief" in this case, therefore, is insufficient because the white list cannot fix the inherent flaw in the charging provision. If section 75A is to be retained then the addition of a motive or purpose test is long overdue.

Group relief

2.5.5 SDLT group relief has become too complicated. In particular, the anti-avoidance provisions in paragraph 4ZA of Schedule 7 Finance Act 2003 have created a lot of uncertainty around genuine commercial transactions. This provision claws back SDLT group relief in certain circumstances where there is a change of control of the purchasing company after the vendor company has left the group.

2.5.6 As with section 75A, HMRC has implicitly acknowledged that paragraph 4ZA has gone too far by publishing guidance on when it will not seek to claw back SDLT group relief even where there has been a change of control that is caught. However, providing reliefs from badly drafted anti-avoidance rules in the form of HMRC guidance does not produce a stable, transparent and predictable tax system.

The need for a complete overhaul of SDLT

2.5.7 Given how difficult it is for leading SDLT experts to interpret and apply the legislation, the OTS will appreciate how impenetrable it must be for taxpayers, conveyancers and other real estate practitioners. SDLT is intended to tax some of the simplest transactions that taxpayers can enter into - the sales of land - but has ended up being one of the most complicated taxes. We hope that these examples have demonstrated the need for the

whole of the SDLT code in Part 4 of Finance Act 2003 and the related schedules to be overhauled completely.

2.6 Real Estate Investment Trusts (REITs)

2.6.1 Although a number of existing property companies converted to REITs when the regime was introduced at the beginning of 2007, there have only been two start-ups. Although market conditions and the fact that existing property companies have continued to trade at a discount to Net Asset Value (NAV) following their conversion are undoubtedly significant reasons for this, the complexity of the rules also presents a significant barrier to start-up REITs. The REIT regime is another unfortunate example of a good policy which has been undermined by unnecessary complexity, fuelled, no doubt, by the general paranoia about avoidance.

2.6.2 There are two points that we particularly want to draw to the OTS's attention.

(a) First, the "close company" condition is too restrictive and complex. This prevents smaller groups of non-close and independent institutional investors forming a REIT and creates an ongoing compliance burden as the condition must be monitored for the life of the REIT. This is very unattractive to institutional investors who are otherwise tax exempt.

In particular, the focus on voting power produces anomalous results. For example, the exception that applies if 35% of the voting power is held by the public does not work as expected in the context of pension and other feeder funds because all of the voting rights are controlled by the manager or trustee of the fund. Many such feeder investors are tax exempt institutions managing funds on behalf of many thousands of individuals.

The close company condition is designed to ensure that REITs are genuinely widely held and prevent "private" REITs being set up by a small number of associated investors. This objective could be achieved much more effectively and simply by replacing the close company condition with a viable alternative such as a variation of the genuine diversity of ownership condition used in the Authorised Investment Funds (Tax) Regulations 2006. Alternatively, the existing close company rules could be amended to allow a look through for pension funds, life companies and other similar "non close" institutions and trusts.

(b) The second point is that the requirement for a REIT to be listed on a recognised stock exchange increases costs and complexity. It is also unnecessary for institutional investors who do not need liquidity or such heavy regulation. In fact, institutional investors often wish to avoid such liquidity because it increases pricing volatility. If liquidity is required at a later stage, the REIT could be listed then. The fact that listed REITs tend to trade at a discount to NAV is also unattractive to institutional investors. With this in mind, we suggest that the listing requirement is removed. REITs aimed at the retail sector would always have the option to list.

2.6.3 We have already made more detailed but informal representations to HM Treasury and HMRC about these and other problems with the REIT regime creating a barrier to entry. We would be very happy to provide the OTS with more detail on these issues if it would assist.

2.6.4 There is strong demand from institutional investors for a viable onshore real estate funds vehicle. Unfortunately, the UK REIT does not provide this in its current form. Fixing the REIT regime would provide a platform to encourage much-needed investment in the residential sector. It could also lead to many more real estate investment funds being structured onshore and to the onshoring of existing structures. This would lead to more investment and more jobs being created in the UK. There is no avoidance motive here. The demand for these changes is principally coming from tax exempt investors, and the extra jobs and investment they would bring would lead to more tax being paid rather than less. We hope that the OTS will consider recommending a formal consultation on reforming the REIT regime, to begin as soon as possible.

2.7 Employment related securities

General need for review

2.7.1 The employment related securities rules are contained in the Income Tax (Earnings and Pensions) Act 2003. The Supreme Court recently gave its decision in the first case to consider these rules, *Grays Timber Products Limited v HMRC*. In his judgment, Lord Walker observed that it *"is regrettable that ITEPA 2003, which came into force on 6 April 2003 and was intended to rewrite income tax law (as affecting employment and pensions) in plain English, was almost at once overtaken by massive amendments which are in anything but plain English"*. He went on to express *"hope that Parliament may find time to review the complex and obscure provisions of Part 7 of ITEPA 2003"*.

2.7.2 We wholeheartedly agree with Lord Walker's comments. The employment related securities rules in ITEPA are another area of tax law that has fallen victim to the blinkered focus on avoidance. We understand the need for HMRC to combat the aggressive schemes which have been used to avoid employment income tax. However, this single minded goal has produced legislation which acts as a barrier to businesses being able to properly incentivise the people who we need to help our economy grow. Mr Gray was not party to an aggressive scheme. He was simply caught out by a complex and obscure set of rules that even the Supreme Court struggled to interpret and apply.

Disincentives to share remuneration

2.7.3 Various governments have expressed a desire for banks and other businesses in the financial sector to remunerate their employees in a way that incentivises them over the long term and does not just reward short term returns. Giving such employees shares is one of the obvious ways to achieve this. However, at present the rules in ITEPA actually discourage this form of remuneration.

2.7.4 Employees who are given shares will typically be taxed on the market value of those shares when they receive them. If they cannot sell the shares for several years they will not have the cash to pay this upfront tax charge. Likewise, if the shares subsequently drop in value they cannot reclaim the tax already paid. Although any growth in value should be taxed as capital, not income, the unfunded upfront income tax charge means that the tax system does not reflect the longer term risk that employees are expected to take.

2.7.5 In some situations most or all of the tax charge can be deferred until a later date, for example by using options. The OTS has identified the exemption from income tax for the

acquisition of employment related securities options[2] as a relief that is subject to its review. However, in our view this relief does not go far enough.

2.7.6 There is generally no tax charge when such options are granted. However, when the option is exercised the employee must pay income tax on the then current market value of the shares, less anything that they may have paid on the grant or exercise of the option. Even if an unfunded upfront tax charge can be avoided, the employee still has to pay income tax. Again, this does not reflect the longer term risk that the employee takes. If he is granted options over a fixed number of shares instead of receiving cash, he is still taking the risk that the value of those shares may decrease or even disappear entirely. The only difference between granting options and issuing shares is that the employee avoids being taxed on value that he may never receive.

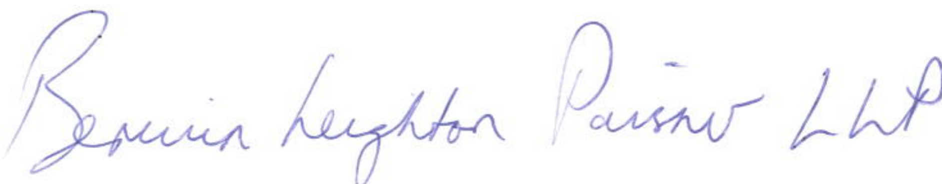
2.7.7 In our view, the rules in ITEPA need to be amended to allow employees to achieve some element of capital treatment when they are required to hold onto shares or options for a fixed period of time. Otherwise there will remain an inherent contradiction between the tax system and the Government's policy of wanting financial institutions to pay bonuses in shares rather than cash.

3 CONCLUSION

3.1 Continuing to focus a disproportionate amount of time on tax avoidance will stifle growth and deter investment in the UK. This will ultimately cost the exchequer more than closing the tax gap will ever save.

3.2 This is not to say that trying to combat avoidance is wrong. In fact, this must continue. Our desire is rather to simply observe that our tax system is out of balance and that the narrow focus on specific avoidance activities has become counter-productive because of the damage that the resulting complexity of the tax code does to business and growth. We agree with the IFS Mirlees Review, which highlights Lord Kaldor's statement as the right starting point for reform of our tax system: "*The existence of widespread tax avoidance is evidence that the system, not the taxpayer, is in need of reform*". We hope that the OTS will encourage the Government to be bold and take on the challenge of completely overhauling the parts of our tax system which are fundamentally broken.

Yours faithfully



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2 Section 475 ITEPA 2003