



Making the taxman work for the taxpayer

Dominic Raab MP

Foreword by John O'Connell

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Foreword

In 2010 the former Chancellor, George Osborne, called the tax system a 'spaghetti bowl'. He was spot on: the UK tax system is hideously complicated, with far too many reliefs and exemptions meaning the Tolley's tax guides now run to nearly 22,000 pages.

I was pleased to be part of the 2020 Tax Commission as it undertook a thorough review of the system, to come up with recommendations for reform to make it simpler. After 18 months of research, evidence sessions and much heated debate the Commission produced its final report, *The Single Income Tax*, in 2012.

The plan called for replacing corporation tax and capital gains tax with a tax on distributed income. It also proposed decentralising tax raising powers to local authorities, while scrapping stamp duty and inheritance tax. The system we recommended is intended to capture flows of income and tax them only once, at the same rate.

With that in mind, I am pleased that the TaxPayers' Alliance is publishing this crucial report by Dominic Raab MP. He has outlined in this paper how our current system is badly skewed against the little guy – and recommends a series of robust measures to make taxes simpler and less punitive.

Dominic deals with new legislation such as the requirement for companies to provide tax updates on a quarterly basis, and argues forcefully that HMRC should compensate taxpayers when they overstep the mark.

He also proposes a more practical role for the Office of Tax Simplification – after all, George Osborne formed the organisation to untangle the spaghetti in the bowl, so they should be given a more formal role to do exactly that.

Dominic's contribution to this debate comes at a crucial juncture: with Article 50 likely to be successfully triggered in the next few months, now is the right time to start a real discussion about the tax system we need as the UK disentangles itself from the European Union and seeks to compete in the global economy.

John O'Connell
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Executive summary

The UK tax code is too long and complex. That has facilitated tax avoidance, undermined UK competitiveness and led to the taxman (HMRC) acquiring arbitrary powers. This report sets out five proposals to simplify the tax system, make it fairer and more competitive, and limit the scope for abuse of small and medium enterprises (SMEs) and individual taxpayers.

In particular, the report recommends to:

Mandate the OTS to simplify the tax code – to strengthen competitiveness and curb abuse

The Office of Tax Simplification (OTS) should be involved in the design of all future UK tax legislation, to prevent complexity that undermines competitiveness and attracts tax avoidance.

Replace Corporation Tax with a Distributed Profits Tax – to boost investment and prevent tax avoidance

The antiquated corporation tax model should be replaced by a tax on distributed profits.

Simplify payroll taxes, cut National Insurance for the lowest paid workers

The government should raise the threshold for employees paying National Insurance to the same level as income tax, currently £11,000.

Protect small businesses, ease the regulatory burden

The government should ensure that the level of turnover to mandate quarterly accounting is set at the same level as required for VAT registration and accrual accounting, at £83,000.^{1,2}

The introduction of quarterly updates should be phased, starting with the largest companies moved first, before applying them to smaller businesses.

Hold the taxman to account

Clear financial penalties should be imposed on HM Revenue and Customs (HMRC) to compensate taxpayers who suffer by the arbitrary use of new powers.

¹ This is supported by the Association of Accounting Technicians (AAT), "AATs three asks for the Autumn Statement", 9th November 2016.

² The House of Commons Treasury select committee have recommended that the threshold should be increased, and that a VAT threshold would be "a simplifying approach", Treasury Select Committee, "Making Tax Digital", 10th report of the session 2016-17.

Introduction

The UK currently has one of the world's most complicated tax codes, with the guidebook running to over 22,000 pages.³ With every additional clause or tax relief that is added, the opportunities increase for the richest individuals and largest companies to try and avoid tax. At the same time, an ordinary taxpayer can find it increasingly difficult to understand how much they should be paying, and why.⁴

An increased focus should be placed on improving and streamlining both the UK tax code and the tax collector, Her Majesty's Revenue and Customs (HMRC). A complex tax code can be easily manipulated. Compared to big business, individuals and small businesses, who lack access to experienced tax lawyers (never mind having a team of them on the payroll), become an easy target. A complex tax code may be relatively little burden for the largest companies, but it can become a huge burden for the small and medium enterprises (SMEs) that are increasingly paying more tax as a result of new target-driven taskforces homing in on them. In 2015/16 HMRC announced a record £248m in evaded tax recovered from SMEs, discovered through analytics platforms.⁵ While all individuals and companies must pay the tax they owe, tax legislation should be fair and clear, if it is to function effectively.

Competitive tax codes can help to make a country more attractive internationally.⁶ As we transition into our post-Brexit future, a modern and transparent tax regime would be another important string in our bow, to ensure the UK remains one of the very best nations in the world to do business in.

Simplifying the UK's tax code, through both straightforward and transformative measures, will reinforce multinationals' confidence in Britain as a leading, competitive, economy in which to base their businesses. Equally, smaller UK businesses will benefit from a simpler tax environment, reducing the time they spend on administration and the costs incurred in complying with the legislation. Overall, it can radically reduce the scope to evade tax through loopholes.

The UK taxman has gained new, punitive powers in recent years, which have corroded the basic fairness of the system. This too is the result of having a complicated tax code that requires heavier-handed policing. New powers include accelerated payment notices (APNs) and the direct recovery of debts (DRDs). Such powers undermine the basic tenets of British justice, allowing HMRC to bully taxpayers into paying debts without proper safeguards.

We need a tax system that is competitive, fair and easy to understand. That will allow Britain to remain open to business – but also ensure that ordinary taxpayers are treated decently.

³ David Martin, "A New, Simple revenue tax code for business", Centre for Policy studies, March 2016.

⁴ OTS, "OTS complexity project", June 2015.

⁵ The Telegraph, "Mapped: HMRC's £540m small business tax grab," 8th July 2016.

⁶ Tax Foundation, "Japan attracting business with corporate tax reform", June 2014

Mandate the OTS to simplify the tax code – to make it more competitive and curb abuse

At an estimated 22,000 pages, the UK tax code is unnecessarily complex.⁷ This compares to Hong Kong's tax code which has just 276 pages.⁸ This added complexity has clear disadvantages. The more complex a tax code becomes, the more opportunity there is for tax avoidance, because there are a greater number of reliefs, exemptions and loopholes.⁹ Businesses can also struggle to calculate the correct tax to pay due to the complexity of the legislation.¹⁰

The UK government recognises the need to simplify the tax code, setting up the Office of Tax Simplification (OTS) in 2010.¹¹ The OTS has made 402 recommendations to the government to streamline the tax code. As of May 2016, over half of these have been accepted, either wholly or in part. Within their first year of operation, the OTS identified 1,042 individual tax reliefs in the tax code. Of these, they carried out detailed reviews of 155 (15% of total) and identified 36 that could be abolished¹² (23% of those reviewed).

The OTS was made a statutory body in the Finance Act 2016, making it a permanent, independent, office from the Treasury. Despite this, it remains a review body, only able to influence legislation after it has been written. It needs to be mandated to check regulations before they hit the statute book, so it filters out politically attractive but counter-productive proposals.

A simpler, well-structured, tax code can boost competitiveness. Minimising the number of unnecessary exemptions, and high marginal rates, prevent the tax system from becoming distorted. By streamlining cumbersome UK tax legislation, these unnecessary reliefs can be removed, creating a better designed system.¹³ Future tax policy should be designed with this in mind. Focusing the government on having a simpler and well-structured tax code would make the UK more business friendly, and curb tax avoidance.

The OTS's mandate should be revised, so it is **involved in the design of all future UK tax regulation from the outset**. It should be tasked to help filter out proposals that add complexity to or distort the overall tax code, with the dual objectives of making it simpler, more competitive and less vulnerable to abuse. That way, the OTS can help prevent further complexity rather than just revising it after the event.

⁷ David Martin, "A New, Simple revenue tax code for business", Centre for Policy studies, March 2016

⁸ The Guardian, "Britain's tax is an incredible 17,000 pages long, surely a dog-whistle to the very rich", February 2015.

⁹ See the Public Accounts Committee, Third report of the session 2014-2015, 9th June 2014.

¹⁰ Smallbusiness.co.uk, "Seven in ten SME owners feel hard done by when it comes to tax, a study finds", 1st September 2016

¹¹ Set up on 20th July 2010 by the UK Chancellor, Rt Hon George Osborne MP.

¹² HM Treasury, "Consultation on the abolition of 36 tax reliefs", May 2011

¹³ Tax Foundation, "International tax competitiveness index", October 2016

Replace Corporation Tax with a Distributed Profits Tax

The current global basis for collecting tax from businesses is outdated. It is based on a business model that existed at the start of the twentieth century, which has now radically changed.

The current tax system taxes companies' profits *where* they are earned, which is a simple exercise for a company that operates in a single geographical location. However, once companies that span several countries, as most large businesses now do, are considered it becomes much more complicated. Such business are taxed on profits made in each of those individual countries, with allowances made for companies to move some profits and costs around to reflect the impact of Research and Development (R&D) and headquarters costs, which tend to be centralised.

This complexity is only increasing as new business models emerge, such as the large tech companies. These firms do not have, or need, the large building or staff footprints in each country that the "traditional" multi-nationals needed to house their manufacturing operations or staff. Companies like Facebook do not need a large physical presence overseas to expand their service into new markets. So, the conventional model for establishing their tax base becomes largely academic, and removed from the real world.

In addition, there are reasonable questions about how a business can – and should - be taxed. Companies are legal constructs filing documents at Companies House. Corporate structures don't ultimately bear the burden of taxation – only people can, whether as employees, shareholders or consumers. Several studies have shown how corporate taxes fall on employees, keeping wages lower. The Adam Smith Institute have found that 57.6% of the tax is passed onto workers through lower wages.¹⁴

With these considerations in mind, the UK should overhaul its increasingly antiquated approach to corporation tax, and replace it with a tax on distributed profits. That way, the business taxes would only be levied once a profit has been taken out of the firm, and distributed through dividends, interest payments and share buybacks to those who actually own it, namely its shareholders and creditors.

Moving to such a tax system that recognises the reality of the modern world has several advantages. First, it prevents corporations transferring the burden of taxation onto employees, because the shareholders and creditors are being taxed directly. For international businesses issuing dividends, those received in the UK would be subject to the tax. This would build upon the current UK dividend tax, with the current tax free allowances remaining in place.

Second, it increases transparency, by reducing the accounting treatment of profit. The calculation of tax is much simpler, as only the sum distributed by the business is eligible for tax. There are no adjustments, and so the tax process for SMEs is far clearer. For large, public companies the process would also be more straightforward, and transparent.

¹⁴ Ben Southwood, "Who pays corporation tax", Adam Smith Institute

Third, UK listed companies would see a tax on all their dividends, and other returns from capital to shareholders, regardless of where they are sent. This is easier for HMRC to monitor, as public companies publish a single dividend number, thereby increasing transparency and reducing tax avoidance.

By taxing UK owners of international businesses, and all the returns from capital of UK headquartered companies, this approach removes the existing problems around taxing a company based on its profitability in each particular country, making taxation more accountable, and reflecting the modern reality of truly global corporations.

Fourth, such an approach would boost the UK's international competitiveness, by removing an arbitrary tax which doesn't accurately reflect business operations. Rather than firms moving UK profits offshore to reduce their UK tax bill, companies would be incentivised to increase their operations in the UK. Equally, since retained profits would now be excluded from tax, re-investment is encouraged as it is tax-free.¹⁵ This would promote a fresh wave of investment into the UK, providing a boost as Britain leaves the EU.

Introducing a tax system which doesn't tax profit, but instead taxes distributed capital, would give the UK a clear tax advantage globally. The idea has the support of the IEA and the 2020 Tax Commission¹⁶. The earlier this approach is adopted, the greater the competitive advantage over countries clinging to the outdated approach. Currently, Estonia is the only country using this tax approach, and it has been ranked by the OECD as the world's most competitive tax environment.¹⁷

While a streamlined tax code will boost investment and increase revenue over the long term, it can also be crafted so that – in the immediate short-term – it is revenue neutral, by introducing a distributed profit tax at the appropriate rate. For example, setting the rate slightly above the current UK corporation tax rate, and below the current higher rate dividend tax, would result in most SMEs seeing their distributed profits increase, while increasing levels of investment.

Simplify payroll taxes, cut National Insurance for the lowest paid workers

By increasing the personal allowance, Conservative government Ministers have taken around 4 million of the lowest paid out of income tax – a remarkable achievement. Nevertheless, it has left the national insurance threshold at the same level, creating a discrepancy, and accentuating the complexity of payroll taxation for individual employees. Income tax and National Insurance apply at different levels. This makes it harder for an employee to decipher the actual rate of tax being paid.¹⁸

This is an unnecessary complication for individual taxpayers. **The government should raise the threshold for paying national insurance to the same level as income tax, currently £11,000.** This

¹⁵ Estonia saw a 20 percentage point increase in investment after moving to this tax structure. See Masso and Merikull, "Macroeconomic effects of zero corporate income tax on retained earnings", *Baltic Journal of Economics*, 2011.

¹⁶ Ibid. See also the 2020 Tax Commission, "The Single Income Tax", May 2012.

¹⁷ Tax Foundation, "International tax competitiveness index 2016", September 2016.

would simplify the tax structure, and build on government policy by cutting taxes for the lowest paid.

The cost to the government of increasing the current threshold for national insurance to the same level as the income tax personal allowance would be around £8bn.¹⁹ This would result in a significant annual saving, for a full time employee on average weekly earnings,²⁰ of around £353. It would give a real boost to families struggling with the pressures of the cost of living.

This tax cut could be funded through a range of possible measures, including a further consolidation of Whitehall departments and agencies, or introducing means-testing for so-called 'grey welfare'.

This could also be a first step towards merging national insurance and income tax, creating a single income tax – a proposal that has been set out in detail by the 2020 Tax Commission.²¹ By unifying these two taxes, employees would be able to clearly see a single tax deduction in their salaries. That would simplify the calculation of 'take-home pay', and the impact of tax changes on those affected.

Protect small businesses, ease the regulatory burden

The government is working on plans to upgrade the UK tax system so that it is more flexible and easier for individuals and businesses to update HMRC. This proposal is known as Making Tax Digital (MTD) and has the sound ambition of making the UK tax system a world-leading regime. The government currently proposes that any business with more than £10,000 in annual turnover would have to "update" HMRC on its accounts once a quarter.

While these quarterly reporting requirements are less stringent than the current annual filing, they will still place a large administrative burden on the smallest businesses. The Federation of Small Businesses (FSB) has estimated this cost to be around £2,770 per year. This amounts to a 77% increase in the average cost of a business's tax administration.²² This increase would put a business with just £10,000 turnover a year under severe financial pressure.

The threshold for the new quarterly mandatory reporting should be much higher than the current proposals. Many groups have called for this low threshold to be raised²³ to relieve the pressure on those small business owners who would be put under most pressure by these proposals. Currently, HMRC allows companies to report using "cash accounting" which is the simplest method of reporting, as long as they have a turnover of less than £83,000.²⁴ This is also the threshold for a

¹⁸ TPA, "National Insurance is archaic, confusing and opaque. Abolish it", March 2011

¹⁹ HMRC, "Direct effects of illustrative tax changes", November 2016.

²⁰ ONS data shows that average weekly earnings in the year to April 2016 were £539, "Annual survey of hours and earnings: 2016 provisional results", ONS, October 2016.

²¹ See footnote 16.

²² Treasury Select Committee, "Making Tax Digital", 10th report of the session 2016-17.

²³ The Federation of Small Businesses, Association of Accounting Technicians, Institute of Chartered Accounts in England and Wales and the Treasury select committee have all expressed concern about this level.

²⁴ Cash accounting allows businesses to only record transactions when cash enters or leaves the business. This is simpler than accrual accounting where transactions are recorded when they are made, and then cash is recognised when it is received, usually a later date.

business to register to pay VAT. Quarterly reporting thresholds should be equivalent to these existing requirements. Having two different thresholds only adds to the confusion a small business owner may face. **The government should ensure that the level of turnover to mandate quarterly accounting is set at the same level as the requirement for VAT registration and accrual accounting, at £83,000.**^{25 26}

The current plans to rollout this system are ambitious, aiming to have a fully digital system in place by 2020. However, such targets need to be implemented in a way that avoids disproportionate disruption to businesses. The government has already delayed the introduction of this quarterly reporting scheme, to 2019, to address some of these concerns.²⁷

It should now go further, and **phase the introduction of the quarterly reporting. Firms should be moved onto this system in stages, with the largest moved first, progressing to include smaller businesses over time.** That would allow those SMEs that are less able to manage the additional accounting and reporting requirements greater time to plan and adjust. It would also enable those with greater accounting resources and IT experience to trial the system first, in order to help iron out any creases. The system would be fully tested in the real world, by those best equipped to trial the new process, before smaller and more vulnerable businesses are added.

Hold the taxman to account

In recent years, HMRC has been given greater powers to crack down on those who have been using tax avoidance schemes to reduce their annual tax liability. Accelerated payment notices (APNs) came into effect in July 2014 and allow HMRC to send payment notices to those who have been found to have been using tax avoidance schemes.²⁸ These notices enable HMRC to demand payment of tax owed upfront within 90 days. This is before the charge can be contested. As of May 2016 50,000 of these APNs had been issued²⁹ and over £2.5bn in tax had been collected.

In the Finance Act 2015, HMRC was also granted a new power called “Direct Recovery of Debts” (DRDs). This allows HMRC to recover debts of over £1,000 directly from the taxpayers’ bank account. This power came into effect in November 2016. There are certain conditions attached to this,³⁰ but the powers are still extensive.

Concerns have been expressed that these two powers offend basic principles of British justice. The use of APNs compels payment, and so presumes guilt, before appeals have been completed. DRDs empowers the state to seize assets directly from taxpayers’ bank accounts. This power is not available to other creditors, and gives the taxman privileged position in claiming monies owed.

²⁵ This is supported by the Association of Accounting Technicians (AAT), “AATs three asks for the Autumn Statement”, 9th November 2016.

²⁶ The Treasury Select Committee have argued that the threshold should be increased, and that the VAT threshold would be “a simplifying approach”, Treasury Select Committee, “Making Tax Digital”, 10th report of the session 2016-17.

²⁷ Jane Ellison MP, Financial Secretary to the Treasury, speaking at HMRC annual conference, 5th September 2016

²⁸ These schemes must have been ruled illegal under the Disclosure of Tax Avoidance Schemes (DoTAS) policy.

²⁹ Economia, “HMRC withdraws hundreds of APNs after judicial review”, 31st May 2016

³⁰ The power can only be applied to those who have passed the timetable for appeals, owe more than £1,000 and would have at least £5,000 in their accounts after the recovery. An HMRC agent must also carry out a face-to-face meeting with the debtor before the recovery can begin.

The practical implementation of these powers has accentuated these concerns of principle. In January 2016 HMRC was forced to withdraw 2,000 APNs after the scheme they were targeting was found not to be covered by the Disclosure of Tax Avoidance Schemes policy (DoTAS).³¹ In May 2016, HMRC was forced to withdraw hundreds more following a judicial review. In the wake of this, Adam Craggs, a partner and head of tax disputes at the accountancy firm RPC, argued that “any taxpayer in receipt of an APN should not assume that HMRC has followed the correct internal processes and exercised its power lawfully.”³²

HMRC has so far used DRDs just twice, on average recovering £39,246.³³ While this suggests only limited use of the power, merely having it on the statute book has had a more far-reaching effect. The power has been used to threaten taxpayers into submission. After sending HMRC officials to knock on doors, an additional £20million in unpaid tax has been collected from those who were threatened with having their debts recovered directly – bypassing normal principles of due process. This legislation allows the taxman to bully taxpayers.

If such wide powers are going to be given to HMRC, there needs to be stronger checks to prevent abuse. APNs can force taxpayers to hand over considerable sums on very short notice, while DRDs allow bullying and intimidation tactics by HMRC. In order to provide a check against arbitrary use, **financial penalties on HMRC should be mandated, where it wrongly issues APNs or deploys DRD powers, to compensate innocent taxpayers who suffer as a result.** This would incentivise greater oversight within HMRC, and prevent the taxman from bullying innocent taxpayers without proper recourse. Any such compensation should be funded from the additional tax revenue, raised by the proper use of these powers, in order to incentivise greater accountability and oversight within HMRC, whilst avoiding any cost to the wider public finances.

³¹ Ibid

³² Ibid

³³ Parliamentary Question, Hansard, 18th October 2016.