Keep it Simple: Proposals to Reduce the Complexity of the UK Tax System

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UK Tax System Out of Control

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The Bow Group, the centre right Think Tank is publishing research timed to coincide with the January 31st deadline for filing tax returns. The research highlights the chaos and complexity of the UK tax system that Gordon Brown 'our prudent and competent chancellor' presides over. The complexity contributes greatly, to the time, stress and expense experienced by millions of people when filling in their tax returns before the January 31st deadline according to Sam Gyimah, Head of Policy, Bow Group.

The case for simplifying taxes has been made by politicians from all parts of the political spectrum. Yet in spite of this apparent agreement on simplification, tax rules and exemptions become more numerous and complex with each budget. The Bow Group's paper offers recommendations on tax simplification that would mean the UK begins to enjoys many of the advantages of a flat tax (as experienced by countries in Eastern Europe) without the disadvantages: by making assessment, calculation and collection of existing taxes cheaper and easier.

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1. Conceptual Framework

1.1. Introduction

The call for taxes to be simplified is not new. In 1969, the Bow Group, published a paper by Geoffrey Howe and Norman Lamont, called 'Politics for Poverty'. The paper included arguments for radical simplification of taxes. Earlier, in 1965, James Callaghan promised to put 'accountants out of business' with his corporate tax simplification proposals[1], while in 1977 Howe, by then a shadow minister, warned that 'we are in danger of being drowned in a sea of exemptions and concessions'.[2]

Even today, there is widespread agreement that the simplification of the UK tax system would be desirable. This consensus stretches across the political spectrum from the Conservative Lord Saatchi to the Labour-dominated Treasury select committee and professional bodies including the Institute of Chartered Accountants, the Federation of Small Business and the British Chamber of Commerce. Yet in spite of this apparent agreement on simplification, tax rules and exemptions become more numerous and complex with each budget.

A simplification of the tax system would need to be deeper than those of 1996 and 2001 which focused on wording of legislation rather than on the underlying complexity of the tax laws themselves. Yet simplification need not lead to radical upheaval of the UK tax system. Taxation could, and initially should, be made much more easily understandable without upsetting the current balance of the tax burden or, to any great extent, the tax paid by any individual.

As noted above, this is not a new topic. Many papers have been written extolling the virtues of simpler taxes. The thrust of this paper is therefore more practical. In this first section I have discussed the advantages of and need for simpler taxes in the context of the UK in 2005. The second section of the paper will offer practical suggestions to simplify taxes while leaving the current basis and scope of taxation broadly unchanged.

1.2. Benefits of a Simpler Tax System

- **Lower compliance costs –** A simpler tax system would make tax assessment and collection quicker and easier. This would result in businesses and individuals having to spend less time and money on preparing their tax returns. Tax simplification is invariably at the top of the list when small businesses are asked about how burdens could be reduced.

  In 2002, it was estimated that 90 million man-hours[3] were spent on completing income and capital gains tax returns, this being before the introduction of the self-assessment system, which has greatly increased the burden on individuals. The complexity of the current tax system creates the need for more people to take financial advice. As a result of this, 25,000 people[4] were employed in the private tax industry in the UK in 2004. Total tax compliance costs in 2002 were estimated at £12 billion.[5] Both tax complexity

[1] Interview with the Financial Times, 1965.
[2] Speech to the Addington Society, 1977.
[3] Cedric Sandford et al, 'Administrative and Compliance Costs of Taxation', 1990
[4] Adam Broke, 'Towards a Better Tax System', Institute of Chartered Accountants, 2000.
[5] Ibid

and the consequent need for advice militate against the less educated members of society.

- **Lower collection costs –** A simpler tax system would require fewer civil servants to administer it. Simplification would also leave fewer loopholes for tax advisers and civil servants to successively discover, exploit and close. As long ago as 1990, tax collection cost £8 billion each year,[6] a figure which will have been subsequently increased by both inflation and subsequent tax complication, most notably the introduction of tax credits***.***

- **Transparency and Accountability -** Simpler taxes make the overall level of the tax burden more apparent and so enable voters to make a more informed decision at the ballot box.

- **Improved Parliamentary Scrutiny** – Longer and more detailed finance bills mean that it is harder for parliament to scrutinize tax changes effectively. Moreover, the fact that 82% of MPs are unable to complete their tax returns correctly[7] questions their ability to keep control of tax rules, such is their complexity.

- **Fewer Errors** – The complexity of the current tax system is in part responsible for millions of people paying incorrect amounts of tax and for the Inland Revenue experiencing difficulties in collecting taxes due:

    - 3.8m people paying tax though the PAYE payroll deduction system are paying tax at the wrong rate (one-eighth of the total)
    - Tax credits were overpaid by £2.2 billion in 2004/5
    - £575m of tax due through PAYE was not collected in 2004/5
    - £9.6bn owed to the Revenue remained outstanding at April 2005, 40% of this amount had gone unpaid for over 12 months
    - £24bn of National Insurance payments due was unpaid at April 2005. Of this, £616m was reckoned to be irreclaimable[8]

- **Less Distortion** – simpler taxes mean that rational economic behaviour is distorted less by quirks of the tax system. Disincentives to earn more are reduced.

1.3. Taxes becoming more complex

In spite of the advantages of simplification, the tax system in the UK has become ever more complex over the last half century. A measure of its increased complexity is the length of successive Finance Acts.[9]

Period	Length of Finance Act (pages)	Size of Pages
1945-64	74	A5
1965-86	189	A5
1987-2004	289	A4

By 2005, UK tax law extended to over 10,000 pages.[10]

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[6] Cedric Sandford et al, 'Administrative and Compliance Costs of Taxation', 1990.
[7] Result of a survey conducted by the Chartered Institute of Taxation, 2001.
[8] National Audit Office Report on HM Revenue & Customs 2004/5, published 10th October 2005.
[9] Robert Mass, 'Why Parliament Fails Taxpayers', Institute of Chartered Accountants, 2000.

1.4. Flat Taxes

2005 has seen a revival of UK interest in the idea of a flat tax – levying a single rate of tax on income from all sources. Flat tax regimes invariably have a relatively high tax threshold to leave a substantial tax-free band of income. Flat taxes have been successfully introduced in several Eastern European countries with rates ranging from 12% (in Georgia) to 26% (Estonia).[11]

Although a flat tax can be seen as the ultimate expression of tax simplification, this paper does not advocate the immediate adoption of a flat tax in the UK. A move to a flat tax with only one rate would involve substantial changes to the distribution of the incidence of tax. If the current 2005/6 level of government spending was left unchanged, a flat tax would have to be levied at 44% to pay for it.[12] Such a rate would not only represent a substantial shift of the marginal rate of tax from 0% to 44% at the threshold, but would also lead to major changes to the tax burden on a large number of taxpayers.

Advocates of a flat tax have suggested that a rate as low as 22.5% could fund UK government expenditure, such an estimate assumes a substantial increase in tax revenues as a result of lower tax avoidance and the additional stimulus given to the economy by lower taxes and lower compliance costs. Such phenomena have been seen in the Eastern European countries where flat taxes have been introduced. However these lessons are not directly applicable to the UK case as the prior to the move to a flat tax, many of the Eastern European countries concerned suffered from widespread tax avoidance and lower original levels of tax take.

Although this paper's main thrust is the simplification of taxes, it is also mindful of the need for the tax system to meet with the consent of the taxed. As was seen with the case of the poll tax, the most likely sources of popular discontent are connected with changes to the balance of the tax burden between different groups within society. Although all reforms to the tax system will change this balance to some extent, it is necessary to move slowly and with public consent to achieve successful reform. It is my view that a direct move to a flat tax system would cause too much upheaval to the tax system and too great a change to the distribution of the burden of taxation to achieve the necessary degree of popular acceptance.

The forms of tax simplification advocated in this paper offer many of the advantages of a flat tax without the disadvantages. They would leave the distribution of the tax take between high earners and low earners and between taxes on income, property, capital gains and consumption largely unchanged, only make the assessment, calculation and collection of existing taxes cheaper and easier. Neither these proposals, nor a flat tax would necessarily lead to a lower tax economy.

1.5. Winners and Losers

All of the complexities, reliefs and exemptions currently littering the pages of UK tax legislation were made in good faith and predominantly with the intention of making the tax system 'fairer' so that no taxpayer paid more tax than was reasonable given

[10] The Guardian, 15th August 2005
[11] John Chown, Flat Taxes: The Case for Radical Tax Reform, Policy Institute, 2005.
[12] Ibid

his, her or its' situation merited. The main thrust of the suggestions given in Section 2 of the paper is to eradicate as many of these 'special case' rules as possible. This in turn would allow the headline rate for each tax to be lowered so that the overall tax take remained largely unchanged.

For example, the Investment Management Association have calculated that a 15% flat rate tax on all savings would generate the same amount of revenue as the combination of the existing higher headline rates less exemptions do at present.[13]

If the whole tax system was simplified on this basis, it is inevitable that some taxpayers will pay more under the new, simpler system than under the old, even though the proposals described below would affect fewer individuals' tax bill than a more radical solution such as a flat tax, or merging income tax and national insurance. The groups so affected, the press and opposition parties would inevitably make much of these specific cases. A government wishing to simplify the tax system and reap the advantages described above would have to be prepared to weather this kind of political fallout, although it could fairly argue that even the adversely affected groups would benefit directly from lower compliance costs and indirectly from savings in collection costs. Nevertheless, as with all changes to the tax system, the proposals would be easiest to implement at a time when the overall level of tax burden is falling

1.6. Social Engineering

The phrase 'social engineering' can have negative connotations, especially in right of centre circles, however there is a role within the tax system for encouraging 'desirable' social and economic behaviours. Notable examples are tax advantages for married couples, for pension savings and for investing in start-up companies and in development zones. This paper does not advocate repealing any of these three tax breaks. However it takes the view that there are currently too many tax exemptions and incentives which obscure the advantages of the most important. The current number of exemptions should be reduced.

[13] Dick Saunders, Proposal of the Investment Management Association to the Treasury, September 2005.

2. Tax Complexity and Suggestions for Simplification

This section comprises a review of each of the major taxes currently in force. For each tax, I have summarised the major rates, conditions and exemptions in force in the 2005/6 tax year and have then made suggestions as to how the tax could be simplified.

2.1 Income Tax

2.1.1 Current Income Tax Rules[14]

In 2005/6, income tax rules included the following provisions:

- 3 rates, 10%, 22% and 40%
- 20% basic rate for non-dividend savings
- 2 rates of tax on dividends, 10% and 32.5%
- 3 different personal allowances dependent of age (up to certain income limits for those over 65 and 75)
- 2 married couples allowances dependant on age (up to certain income limits for couples of over 65 and 75)
- Blind persons allowance
- Life assurance relief (policies issued before 14.4.84)
- Rent a room relief
- Working Families and Children's Tax Credit (see below)
- Relief for fluctuating profits for Farmers and market gardeners and creative artists
- Allowable limits for payments into personal pensions and retirement annuity premium schemes (different, each has 6 age-related bands) – can carry back and forward personal pension contributions Earnings cap on personal pension contributions
- 42 professions have different allowable retirement ages
- There are five different times when employees' bonuses may be accounted for and taxed, depending on circumstances.
- Limits for tax free severance pay
- Limits on statutory sick pay
- Tax free limit on maternity pay
- National savings bank tax-free interest limit
- Sole traders face restrictions in carry tax losses back or forward to set against past or future profits. They may also face complicated rules regarding the amount of income that is taxed when they start or end their business in the course of a tax year, including being liable to paying 'double tax' on certain months early in their business' life, money that is not refunded until the business closes.

<u>Benefits in Kind</u>

The rules for calculating the taxable value of benefits received from an employer in kind are especially complicated. They include:

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[14] All data in this section on current tax rates and allowances is sourced from Hardman's Tax Rates and Tables, Institute of Chartered Accountants & Chartered Institute of Taxation, 2005/6 Edition.

- 6 different percentages of list price depending on business miles driven and whether an employees first or a subsequent car
- 21 different percentages of a cars full value charges depending on whether, and to what degree, a car has an approved CO_2 emissions rating
- 3 separate percentage charges on a cars full rate value if car runs an alternative fuel
- 3 different petrol benefit scales depending on cylinder capacity of cars
- 2 different diesel benefit scales depending on cylinder capacity of cars
- 3 van benefit scales depending on age
- 4 different rates of mileage allowance payments
- A tax-free relocation allowance, a separate allowance on payment on loss of office and unemployment
- 2 separate tax-free incidental overnight expense limits for UK and overseas (as low as £5 and £10)
- Fixed sum allowances for employees who repair and maintain their own equipment. 78 professions eligible, receiving different allowances
- 8 different tax treatments of schemes giving employees shares in the company for which they work, or a share of the profits

<u>Other Income Tax Reliefs</u>

- Payroll giving limits
- Investment Income: PEPs, ISAs (4 types) and TESSAs
- Tax free limits on small maintenance payments (to former spouses or children)
- Limit on settlements given to minor children (separate limit)
- Tax relief on medical insurance premiums for those over 60, providing taken out or renewed before 2.7.97

In addition, tax relief is given on investments in:

- Enterprise investment schemes
- The Business Expansion Scheme
- Venture Capital Trusts

There are 13 state benefits which are liable to income tax and 36 which are not.

2.1.2 How to Simplify Income Tax

<u>General</u>

- Reduce the number of tax bands to three – tax-free, basic and higher. – possibly by raising threshold entirely to 22% level or by starting at 22% at an intermediate rate. This would involve abolishing the 10% band which covers only £2,090 of income, realising £209 of tax per person. This is so small as to be almost gimmicky and it would be easier to abolish the band and in recompense increase the size of the tax free band. This measure would also help the lowest paid the most.
- Make all benefits tax free to avoid tax churn – the government paying money to itself (with the attendant loss through administration costs). Tax churn was estimated at £20-40bn pa, even before the introduction of tax credits. Where benefits were paid tax free, the headline rate of the benefit would fall but the net amount paid would remain the same.

- To compensate for the loss of tax exemptions, increase the income level at which income tax is first paid.
- Each person should have one personal allowance, irrespective of age or whether married or not, however married couple should be able to transfer their personal allowance between each other, to whatever extent they desire.

Savings

- To encourage saving among the less well off, make interest on savings or dividends tax free within the basic rate band.

Sole Traders

- Allow sole traders' losses to be set against all forms of future or prior profits.
- This more generous ruling would allow all industries to be covered by the same regulation, rather than having separate rules for volatile industries.
- Remove the iniquitous system of 'overlap profits' by which a sole trader's income can be taxed twice in the early years of a business when it is at its most vulnerable.

Business Incentives

- There should only be one tax regime covering profit-related pay and share options rather than eight. Share options should simply be taxed on the benefit received on the date of exercise.
- There should only be one type of tax incentive to invest in small businesses rather than two.
- There are currently over 40 types of business aid and support schemes – these could be simplified along with their tax treatment and so make it simpler for hard pressed businesses to apply for and to receive support.

Benefits in Kind

- All benefits in kind should be assessed either at the cost to the employer or, if a long-term asset, their value spread over their useful economic life. This cost information may be found in statutory accounts and a useful by-product of this reform would be to partially bridge the gap between statutory accounts and tax accounting.
- Rather than the complicated rules which determine the taxable value of company cars, simply divide list price of the car by four and treat as income over the first four years of use.
- Fuel for private use should simply be charged simply at the cost to the employer, as recorded in expense claims.
- All bonuses and lump sums should be accounted for when physically paid.
- Golden hellos and handshakes, payment in lieu of notice and other lump sums (with the exception of compensation for disability) should be taxable and charged on receipt, rather having a different set of complicated rules to deal with each.

Gifts

- There should be one scheme rather than gift aid with its differing minimum values for individuals and close companies

- The tax-free allowances on maintenance payments and payments to minor should be abolished and swept into the higher tax-free threshold

2.2 Pension Saving

2.2.1 Current Pensions Tax Rules

The UK pension system has developed in stages over the last 90 years, each successive reform adding a further degree of complexity. Now, when demographic pressures mean that it is more important than ever that individuals save more for their retirement, the complexity of the system both impedes their assessing their current provision for old age and hinders their making further investments to improve it. Means tested benefits and restrictive annuity laws also create disincentives to save for retirement. The UK pension's regime needs to be radically simplified to resolve these problems.

Responsibility has been thrust more onto the individual to provide for his or her old age. The individual needs to be given the power to go with the responsibility of providing for his or her old age. This means simplifying the pensions system so that more people are able to understand it and assess how much they need to save for retirement. It also means giving individuals greater freedom to invest their retirement savings where they wish and in how they utilise those savings once they retire.

Current Complexities and Disincentives

- The structure of personal pensions and their attendant tax incentives in the UK is highly complex. There are eight different Inland Revenue regimes and over twenty sets of tax rules relating to pensions.

- As the minimum income guarantee is now higher than basic state pension it is currently illogical for low earners to save for pension.

- Retirees are required to take out an annuity by the age of 75. The gamble involved in timing the taking out of an annuity goes against the principles of prudence and security which pension provision should embody.

- Benefits arising from annuity are lost on death and cannot be passed onto the retiree's heirs. In addition to being iniquitous, it also does not benefit the state if relatives of the deceased pensioner are forced to rely on benefits as a result of the loss of the annuity fund.

Advantages of Simplification

For the free market to function effectively, adequate information must be available. The market has not led people to save an adequate amount for their retirement as two key calculations are obscured:

- The level of retirement income that can currently be expected.
- Whether one pension's product offers a better return than another.

At present, the multiplicity of potential income sources and tax treatments obscure these calculations and in turn lead to market inefficiencies and under-provision for retirement.

Pension simplification would also mean that a lower proportion of contributions would have to be paid out in advisory and management fees, increasing the size of the ultimate pension fund.

These benefits would be most apparent for people on lower incomes and with less financial knowledge, the groups who most need to be encouraged to save more for retirement.

2.2.2 How to Simplify Pension Provision

Principles Underlying Proposals

Freedom

Although the state may wish to encourage saving for retirement, the individual should retain the basic economic right to favour immediate consumption over deferred consumption.

No Disincentive to Save

To balance the right to economic freedom described above, those who choose to save should not be discouraged from so doing. To this end, means-tested or discretionary benefits should not be used to top up the incomes of those who have not made individual provision for their retirement.

Proposals

In the future there should be only two tiers of retirement provision; the Old age Allowance and the Individual Pension Fund. In addition to simplifying the pension's regime, the flat-rate Old Age Allowance would reduce disincentives to save while the flexible Individual Pension Fund would enhance the freedom and ease with which retirement savings may be made.

Old Age Allowance

All UK citizens over 70 would receive a flat rate income from the state. This allowance, set at a very basic level, would be received regardless of the number of years worked or other sources of retirement income and would replace the existing basic state pension and means-tested benefits.

This Old Age Allowance would therefore provide a basic income for those who have been unable or unwilling to make further provision for their retirement. Unlike the current basic state pension, it would provide non-means tested support to those who had worked irregularly or taken time off to bring up children. There would be no additional means-tested or special circumstances benefits, except in the case of disability or severe illness. As the Old Age Allowance would not be restricted by other forms of retirement income, there would be no disincentive to make additional provision for retirement, even for those on modest incomes.

The cost of the Old Age Allowance would be mitigated by its only being available from age 70 onwards. This effective increase in the state retirement age is justified by the shifting demographic balance and the fact that people live longer than ever before. Furthermore, 70 was the original age at which old age pensions were provided and in the modern economy there are many more jobs which do not require great physical exertion and which a 70 year old could do equally as well as a 65 year old.

Individual Pension Fund

Supplementing the Old Age Allowance would be an Individual Pension Fund. The Individual Pension Fund would combine all contributions currently paid into the basic state pension and the second state pension, company and personal pension schemes. The funds could be invested as the individual wished and would be paid out in a lump sum at 65.

Abolition of Second State Pension

Under the new pensions regime, the second state pension would be abolished. There can be little justification for the retention of a nationalised investment fund that has consistently under-performed the private sector. As both the basic and second state pensions are based on national insurance contributions, their abolition would see employees' national insurance contributions reduced accordingly, although the extent of this rebate would be reduced by the need to pay for the universal Old Age Allowance.

Contributions

The key advantages of the Individual Pension Fund are its simplicity and the freedom that it gives to the individual saver. The only restriction on contributions would be a flat rate cap on the amount that may be invested tax free in an Individual Pension Fund in any one year. The current ceiling on contribution, based as it is on salary and age, discriminates against the younger and lower paid workers who are those who need to be encouraged most to save more for their retirement. Any contributions above the cap would not attract tax relief.

Under the Individual Pension Fund, individual and company contributions could be made to as many pension plans as was desired. The funds available to be invested would be boosted by the reduction in national insurance as a result of the abolition of the second state pension.

Investments

There would be no restriction on the type of assets that pension schemes could invest in. The individual saver would have the choice of either investing in a registered fund or in making their own investment decisions in a tax-free 'wrapper', as is presently the case with a self-select ISA. The individual would also be free to transfer their funds between pension scheme providers at will without penalty and invest in as many different funds as desired. The only condition for the investments to attract tax relief would be that they would have to remain in the plan until the investor turned 65.

Private sector pension providers would continue to operate their schemes as at present and companies could either continue to operate their own pension schemes or pay contributions into an employee's own scheme as desired. The funnelling of national insurance contributions into private schemes and the lifting of the tax-free investment limits for younger workers should also serve to increase the level of funds under management and so potentially reduce operating costs per pound invested. Companies could also continue to operate Final Salary schemes if they wished although such schemes are likely to diminish in number in the future as employees change employer more and more frequently.

Retirement

On reaching the age of 65, the total of the Individual Pension Fund would be paid to the individual as a lump sum. There would be no need to purchase an annuity or even allocate a portion of the final fund to providing what was deemed to be an 'adequate' lifetime income, as under the Pickering proposals. Rather the individual would have complete freedom to spend (or re-invest) their money as they wished and if they spent it all within the first year they would henceforth have to subsist on the Old Age Allowance. Should the saver die before or after 65, the contents of the Individual Pension Fund would be able to be passed on to their heirs, in the same way as other assets.

Regulation

The pensions' mis-selling scandals of the late 1980s and early 1990s involved savers being advised to their detriment to leave a company pension scheme or to opt out of SERPS to start a private pension scheme. In the wake of this mis-selling, stringent regulations were introduced to cover the selling of pensions. As with all regulation, it introduced extra cost for the pension provider which is ultimately passed on to the policyholder through an increased management charge. The FSA has calculated the cost of compensation under the pension mis-selling investigation at £11.8bn.[15]

Under the new pensions regime there would be no need for a saver to leave a company pension scheme to invest in a private scheme and no second state pension system to contract out of. Consequently the problems which pension mis-selling legislation was brought in to remedy would no longer exist. The general simplification of the pension system described above would also make it much easier for the ordinary investor to understand the options available to him without the advice of a financial advisor.

It would therefore be possible to greatly reduce the legislation in place against pension mis-selling. Indeed there is no reason why purchasing a long-term savings product under the umbrella of the Individual Pension Fund should be any different to purchasing shares or opening a bank account. Consequently, cases of mis-selling would be confined to those rare cases where a policy contained incorrect written terms rather than encompassing retrospectively-judged bad advice.

As a safeguard against acting on bad advice, it would be a condition of recognition of a scheme under the Individual Pension Fund umbrella that investors should be able to transfer their funds with one provider to another without penalty. Such a measure would thus allow investors an indefinite 'cooling off' period, as opposed to the mere two weeks allowed by current legislation. It would also prevent actions such as that of the Equitable Life in July 2002 by which policyholders had to surrender 20% of their funds in order to exit the policy.

Better-Informed Savers

The new pensions regime would leave savers much better informed as to their likely future retirement income and so leave them better able to judge whether they need to make further provision.

- The flat-rate Old Age Allowance would show clearly the income level if no further provision was made for retirement.
- At the end of each fiscal year, all pension providers under the Individual Pension Fund would have to send a statement to each saver showing the current value of their fund.

Implementation

The implementation of these proposals would have to be phased in over time. The changes to investment limits and to options on retirement could be introduced immediately, however the ending of the second state pension and the transformation of the basic state pension into the Old Age Allowance would have to be phased in over a number of years. Most significantly, repaying the contributions made through national insurance to all workers would place severe strain on government finances.

The best way to introduce the changes in a reasonably timely fashion and to ensure fair treatment would be for younger workers to receive as a lump sum the actuarially-determined value of their contributions into the basic and second state pensions.

[15] FSA Press Release, 27 June 2002

Older workers could have their contributions towards these benefits 'frozen' as the contributions to a company pension fund are if an employee leaves the company. These older workers would then receive the value of their contributions into these funds when they retired, along with any subsequent investment into their Individual Pension Fund.

2.3 Tax Credits

2.3.1 Tax Credit Rules

Tax Credits were introduced in tax year 2001/2 with the intention of boosting the income of low income working families. In 2005/6 the major tax components of and qualifications for tax credits were:

Working Tax Credit

- 5 basic components which determine the maximum amount due – basic, disability, 30 hour, second adult and lone parent
- Different amounts are due if recipient is over 50 and again of the over-50 recipient works more or less than 30 hours per week
- The state will pay up to 70% of the cost of childcare, up to a maximum which varies depending on whether the family has one or more children

Child Tax Credit

There are 2 components:

- Family component - varies if family includes a child under one or not
- An additional sum is payable for each child, a higher sum if the child disabled or severely disabled

Withdrawal rates

The maximum amount of tax credit is received if £5,520 or less is earned per annum. Above this sum, 37p of each pound of tax credit due is deducted until household income is above £50,000, whereafter 6.7p is lost per extra pound earned. If a household only receives child tax credit, the amount due does not start to decline until household income reaches £13,910.

Problems with Administering Tax Credits

The complexity of tax credits has led to errors in their payment.

- £961 million overpaid in tax credits from 2001-3 is likely to be written off as bad debt
- In 2003/4, 1.8m tax credit claimants were paid a total of £460m.
- Out of £13.5bn paid as tax credits in 2004-5, the Revenue admits that overpayments of £2bn were overpaid.[16]

A further complication arising from tax credits is that, because they are available so far up the income scale, the interaction of tax and tax credits could lead to a marginal

[16] National Audit Office Report on HM Revenue & Customs 2004/5, published 10th October 2005.

tax rate of 78% for some individuals - (a single parent earning £37,500 with 2 children and claiming full childcare part of working tax credit. If he/she received a £2,500 pay rise, net income would go up by only £550.)[17]

2.3.2 Simplifying Tax Credits

The paper seeks to simplify existing taxes (and credits) rather than to abolish them entirely and propose new measures. It is harder to simplify tax credits while retaining their essential essence in this way than it is to do the same with other taxes. This is because, at heart, Tax Credits are not part of the tax system at all but benefits.

Options to simplify the Tax Credit System are:

a. Raise the tax threshold

As part of this paper's overall proposals, we could cancel the entire tax credit system and use the savings to increase the initial income tax threshold. This would focus relief on the poorest, limit tax churn and make administration simpler, cheaper and less error-strewn, as opposed to the present system when individuals earning up to £58,000 pa can receive tax credits and the administrative system frequently overpays.

b. Account for Benefits as Such

If, after the introduction of the above, it was modelled that some vulnerable groups, such as families with disabled children were likely to lose out heavily under the new proposals, means-tested benefits could be paid, tax-free, directly to these groups. These benefits could either be on a sliding scale, as with the current tax credits, or at 'stepped' flat rates for different income levels. The latter option is less scientific and has the potential to lead to economic disincentives, but is simpler to administrate.

Accounting for tax and benefits separately in this way is both the correct accounting treatment and also makes the true level of benefits clearer. By taking people out of tax altogether, we would also restore their freedom to choose how they spend their money, rather than being reliant on state hand-outs and then being directed in how to spend it.

2.4 National Insurance Contributions

2.4.1 National Insurance Rules

There are at present 5 classes of national insurance contributions:

Class 1	Paid by employees and employers on standard remuneration, above a weekly, monthly or annual threshold. Separate Rates paid by those who have contracted out from the second state pension. The over 60s pay a reduced rate, and married women also have the option so to do.
Class 1A	Paid by the employer on benefits in kind received by an employee

[17] Ian Luder, Commentary on the 2005 Pre-Budget Report, Grant Thornton, 2005.

Class 2 Paid at a flat rate by the self-employed. Share fishermen and volunteer development workers pay at a reduced rate

Class 3 Voluntary contributions to improve an individual's contribution record

Class 4 Paid by the self-employed on their profits

Classes 1 and 4 are payable at the standard rates up to an upper threshold, and thereafter at 1% (from 2003/4).

2.4.2 How to Simplify National Insurance

Merging Tax and National Insurance

Despite its name, National Insurance has never functioned as an individual or a collective ring-fenced fund to provide pension and other benefits. It is to all practical extents and purposes, a form of supplementary income tax. In theory, unless national insurance contributions were to go towards a genuine form of social insurance (eg. health or education vouchers), it would be clearer and fairer to include employees' national insurance contributions with income tax, with a corresponding adjustment of thresholds.

However there would be strong practical difficulties in pursuing such a course. There are two basic options to combine income tax and national insurance:

1. Keep the existing rates and thresholds and simply combine the billing and collection procedures

Such a system would mean that no-one paid any more or less tax than at present, but would complicate income tax rather than simplify it. Income tax and National Insurance have different thresholds (£4,895 and £4,264 respectively). More significantly, whereas the marginal rate of income tax rises from 22% to 40% at £37,295, the marginal rate of Class 1 National Insurance contributions drops to 1% at £32,760. Consequently, merging the two systems as they currently stand would leave a combined marginal rate of 33% (assuming employee not contracted out) for income up to £32,760, followed by a drop to 23% for the £32,770 to £37,295 tranche and thereafter a rise to £41% for incomes above £37,295. There is of course no reason why such a regime could not be implemented but it would not sit well with the tradition of progressive taxation in the UK, or with our aim of simplification.

2. Combine Income Tax and National Insurance Rates into a Single Progressive System

Such an approach would result in a simpler and cleaner model than that discussed above. However any attempt to implement such a model while raising the same amount of money as the old, un-merged, systems would result in a much heavier burden falling on middle income earners. As such, is unlikely to be acceptable to the public at large and therefore be politically practical.

Simplifying the Existing System

- Abolish Class 1A, charge employers' contributions on benefits in kind along with general remuneration (so fitting in with the proposals on income tax above)
- Class 2 provides only a small proportion of the self-employed's national insurance contributions. It could be abolished and the rates charged under Class 4 raised in recompense
- In line with the proposals on pensions above, it would no longer be necessary to keep up national insurance contributions to guarantee a full pension, or to make contributions into a separate second state pension. Class 3 could therefore be abolished, along with the separate 'contracted out' rate within Class 1.

The above reforms would leave a single employee's class of contributions, a single employers' class and a single class for the self-employed.

2.5 Capital Gains Tax

2.5.1 Current Rules

For a tax which raised only £2.5bn in 2001-2 (as compared to £104bn from income tax), capital gains tax (CGT) is a highly complex. Its main features are:

- Goods with a sale price of less than £6,000 are not currently liable to tax.
- Three tax bands, mirroring income tax rates
- In calculating capital gains tax, allowance is made for inflation since the date of purchase. Currently, whenever the method of calculation is changed, the change is not made retrospective. Consequently an asset purchased in 1982 and sold in 2002 would require four different inflation calculations to be made on its value at different points. The most recent method, taper relief, differs between business and non-business assets. Still further methods are used to asses the tax due on shares and leases.
- Different thresholds for individuals and for non-defined trusts
- Re-investment relief and roll-over relief are available (for defined assets)
- Lease premiums are currently split, by a plethora of complex criteria, and taxed under both capital gains and income tax. Cars worth more and less than £12,000 have different tax treatments.
- Residential property is sometimes under the scope of CGT and sometimes not.

2.5.2 How to Simplify Capital Gains Tax

The most radical simplification that could be made to CGT would be to abolish all of its separate provisions and simply to assess capital gains under income tax as they arise. Limited companies' capital gains are combined with income in this way. However such a change would lead to a dramatic rise in CGT bills as taxpayers would lose the advantage of the annual CGT exemption, for to apply a separate CGT exemption to the income tax assessments of all taxpayers would prove too costly.

Nevertheless, we can make several recommendations for the simplification of CGT as it is presently constituted:

- The greatest simplification that could be made to CGT calculations would be to apply a single inflation calculation to the cost price of assets, rather than applying up to four in succession, as is currently the case. A single

calculation, based simply on the official RPI (or even, more simply, taper relief – would be simpler but less precise) should be applied retrospectively to all assets
- Abolish roll-over and reinvestment relief (which, in any case only apply to certain categories of assets)
- The consideration received for the assets sold should also make no difference to the tax treatment.
- Regard all lease premiums as 100% income.
- Residential property should be exempt from CGT when it is actually occupied.
- As with income tax, in recompense for the abolition of exemptions, raise the CGT threshold to take more people out of the reach of the tax altogether.

2.6 Inheritance Tax

2.6.1 Current Rules

Considering that it raises less than £3bn pa, Inheritance Tax (IHT) is a complicated tax to calculate and collect, to the extent that 10% of revenues raised by it are used up by the costs of collection.[18] Of all the taxes under consideration, a better case could be made for the abolition of IHT on the grounds of efficiency and fairness than for any other tax. However presuming that IHT is to continue, there are a number of areas in which it is at present overly complex.

Reliefs currently available on IHT include:

- Taper relief, reducing the amount of due depending on the length of time that the asset has been held
- Relief on defined ‘business assets’ and ‘agricultural business assets’
- Quick Succession Relief, applying if gifts are passed between people who die shortly after each other.
- Exempt limits for gifts given in consideration of marriage
- Annual exempt limits for small gifts.
- Transfers within 7 years of death are also subject to IHT, the proportion chargeable under CGT diminishing the longer the asset has been held by the recipient on the death of the donor.

How to Simplify Inheritance Tax

- Raise the threshold significantly to make only the super-rich liable, as was formerly the case.
- Exclude residential property from the scope of inheritance tax.
- In recompense for these tax-cutting reliefs, taper relief would be abolished
- The annual small gifts exemption and the exemption for small gifts given in consideration of marriage would also be abolished in the name of simplicity and because they are of such (relatively) small value as to be inconsequential in terms of the size of estates likely to remain under the scope of IHT.
- Apply the same exemption rules to agricultural and to other business assets.

[18] Dr. Barry Bracewell-Milnes, ‘Free Wills: Inheritance Without Taxation’, Adam Smith Institute, 1995.

2.7 Corporation Tax

2.7.1 Current Rules

Taxation of Profits

At present, Corporation tax may be charged under five different tax treatments, depending on the profitability of the company:

- Starting Rate
- Marginal Relief between Starting Rate and Small Companies Rate
- Small Companies Rate
- Marginal Relief between Small Companies Rate and Full Rate
- Full Rate

The effect of the two bands of marginal relief is that companies whose level of profit falls within them face a higher marginal rate than companies in the profit bracket immediately above.

Separate rules apply for Close Companies and Close Investment Holding Companies (types of companies owned by fewer than five people).

Losses

If a company makes a loss in an accounting period, it may set this loss against profits made in a different division or in a prior or subsequent time period. However the ways in which losses may be utilised in this manner are circumscribed by complicated regulations.

Capital Allowances

Businesses are allowed to claim tax allowances against capital expenditure, the taxable value of the asset depreciating over time. The first year of the assets life is eligible for the 'first year allowance' and subsequent years for the written down allowance, until the whole value of the asset is written off.

There are six different types of eligible companies and groups. Between them, these categories can get allowances for 13 types of capital expenditure at different rates for the first and subsequent years.

Separate rules apply for development zones, flat conversions, dredging, mineral extraction and 4 separate R&D related categories

2.7.2 How to Simplify Corporation Tax

Tax Rates and Taxable Profits

- There should be a rationalization of corporation tax rates to zero, basic and higher. The best way to help small companies is to take more of them out of

corporation tax altogether by raising the profit level at which corporation tax is still paid.
- The anomaly by which medium-sized companies are taxed at a higher marginal rate than large companies is a disincentive to grow small businesses and should be removed. (This would involve the replacement of marginal relief which would also simplify the calculation of corporation tax.)
- The differences between profit as recorded in accounts and profits chargeable to tax.

Losses

- Allow companies to carry all losses forward or back against any form of profit, disposing of the need for separate rules for the profits of different trades, interest and loans.

Capital Allowances

There should only be one treatment of Capital Allowances for all fixed assets and for companies of all sizes.

Rationalization of other Treatments

- For tax purposes, treat all interest and dividends as paid gross of tax, rather than adopting differing treatments depending on circumstances.
- Use standard CGT rules to cover the disposal of debt instruments and the transfer of stock between group companies, rather than applying special treatments

2.8 VAT

Value Added Tax (VAT) is a very complicated tax. However the basic nature of VAT is defined by European Union treaties as part of the revenues raised by this tax go to pay the running costs of the EU. It is therefore more difficult for the UK government to make sweeping unilateral changes to VAT than to other taxes, even though the replacement of VAT with a sales tax on the final sale of goods to the consumer could be easier to administer.

Most types of goods or 'supplies' are categorised as being subject to VAT at the full rate of 17.5%. However there are exceptions. 16 categories of supplies are 'zero rated' for VAT purposes, meaning that the supplier can reclaim VAT charged on purchases but that VAT is not charged on onward sales. A further 7 categories of goods are subject to VAT at a reduced rate while 15 categories are exempt from VAT or outside its scope altogether.

Taken together, these exemptions from VAT reduce the potential tax take from VAT by around one third. It would be consistent with some of the other recommendations of this paper to advocate abolishing these exemptions and lowering the rate of VAT, or raising the level of the threshold at which companies have to apply for VAT-registered status. However I would be loathe to treat VAT in this way. For if we were to lower the VAT rate while reducing the number of zero rated and exempt goods, it would lead to an increase in the price of basic goods such as food, which would be politically unacceptable.

Further complexities retained within VAT are:

- VAT charged on fuel for private journeys if supplied at a subsidised business rate. This VAT is charged per car and there are 5 different rates depending on the cylinder capacity of the car and the type of fuel that it uses. As with Income Tax on benefits in kind, above, this treatment could be simplified by charging the fuel to income tax at market rates.
- VAT also impacts on purchases of capital goods by companies part of whose business is within the scope of vat and part without

2.9 Other Taxes

<u>Stamp Duty</u>

The threshold at which stamp duty starts to be paid, and the rate at which it is charged depends on the interplay of the following factors;

- Sale price
- Whether residential or on-residential property
- If the property is located in a designated disadvantaged area or not.

In all, nine different stamp duty treatments may be applied to property and four to sales of land. In addition, there are five rates of stamp duty charged on leases, depending on the length and value of the lease and two rates of stamp duty on rental agreements, depending on whether the rented property is for residential or non-residential purposes.

Stamp duty could be rationalised in that the distinction between residential and non-residential property and the distinction between leases of different lengths could be abolished.

<u>Landfill Tax</u>

Landfill tax is collected from the operators of landfill sites and is charged on the volume of waste deposited. Different rates are charged depending on whether the waste is designated as ‘active’ or ‘inactive’. Landfill operators can claim up to 18% of tax paid back as a tax credit for payments to environmental trusts (although the legislation does not express it so simply) and up 6% of annual tax paid back as a credit for payments to ‘bodies concerned with the environment’. This last distinction could be abolished.

2.10 Overseas Taxation

Aspects of the inter-relation of UK with overseas taxation are highly complex, however reform would require re-negotiation of external tax treaties. Such re-negotiation would require the consent of foreign governments and is outside the scope of this paper.

One area which could be reformed by the UK alone however is setting conditions for UK tax residency.

Nevertheless, there should be only one set of rules covering UK residency for tax purposes rather than separate rules applying under income tax, CGT and inheritance tax legislation.