04 September 2024

TaxWatch is the only UK focussed think tank conducting research into tax compliance and administration. We are a registered charity and non-partisan – we advocate for good tax design and legislation which minimises the opportunities and incentives that drive tax avoidance. Tax should be easy enough to understand and predictable enough to encourage voluntary compliance. Resourcing HMRC appropriately to administer the regime well is fundamentally important to collecting the revenues that Parliament has legislated for.

The UK's long run productivity has been dismal in absolute terms and relative to comparator countries. The new Government is rightly focussed on stimulating economic growth and attracting productive investment into the UK. The tax system has a role to play in this objective. However, the current tax regime is holding a lot of economic activity back and/or creating incentives that favour some forms of income and business structures over others which exacerbates inequality between taxpayers and undermines public trust in the public finances.

One of the main consequences of these differing incentives and tax treatment is that it exacerbates the Tax Gap, and requires more compliance resources within HMRC to police returns and make interventions to secure the revenues due. HMRC have been starved of resources through austerity and the situation is now critical. It is also self - defeating. If HMRC is unable to collect taxes effectively, the rest of public services face greater cuts than necessary or desirable. A new approach is needed. Labour's 'Closing the Tax Gap' report is very welcome as it demonstrated that the incoming Government had considered the scale of the challenge before the election was even called.

This summary of reforms looks across the tax regime and seeks to improve one or more of the following:

1. Simplification of the regime, to improve compliance and help remove complexity that can be exploited by promoters of tax avoidance and evasion, and their clients.
2. Policy design, to remove cliff edges and different tax treatments, removing incentives to change behaviours wholly for purpose of minimising tax.
3. Revenue raising, noting that the public finances are under unprecedented pressure and commitments made in the pre-election period have reduced options on the main revenue streams.

Tax policy is a set of choices and some of the measures are politically difficult. Many of them have clear 'losers'. We have attempted to anticipate these challenges and where there are options that partially mitigates the downsides we have mentioned these. We

have also considered how radical a suggestion each item is, and whether it could be linked to stated policy goals elsewhere in the Manifesto for Change. We aren't in a position to accurately cost the measures but where the measures are being suggested to raise revenue, we do suggest that costings are commissioned from the OBR.

1 Asset taxation

For CGT and IHT there are many instances where the taxes interact with each other at the point of death or when assets are gifted into a lifetime trust. These interactions create incentives to structure finances in specific ways, with significant implications for intergenerational transfers of assets and equity. The interdependence of taxes, and how these marry together into a holistic regime, naturally lends itself to a package of suggested measures below, rather than a small number of individual measures, where the overall impact would be undermined by the continuance of others. For example, removing the uplift for IHT on death would have no revenue impact if all the assets bequeathed at a gain are exempt or covered by unreformed Business Asset Disposal Relief.

1.1 Capital Gains Tax

Capital Gains Tax (CGT) is the main way the UK taxes appreciation in asset values for private individuals (with corporate chargeable gains for UK corporate tax purposes where the owner is a UK resident company). CGT collects relatively modest amounts of revenue (and the UK is therefore low down the international comparators for wealth taxation overall) for three main reasons:

1) The narrow tax 'base' with big asset holdings not chargeable to CGT at all due to blanket exemptions, for example all investments held within ISAs or pensions. In addition, all assets held at a gain on death are uplifted to their probate value meaning there is a very strong incentive to hold onto assets in later life to be passed on with no CGT for the descendants.

2) Generous exemptions, some of which are very poorly targeted. For example, principal private property doesn't just exempt the primary residence for the proportion of time the individual lived there, there's complicated rules allowing individuals with their spouses to flip residences and relief given for permitted non-resident periods. The snappily named Business Asset Disposal relief (or appropriately shortened to BAD relief) is mistakenly presented as an incentive driving entrepreneurship when it is so loosely drawn that it achieves little of this policy aim and instead is very easy to exploit.

3) Low tax rates, taxing gains at the reduced CGT rates of 10/18% and 20/24%, dramatically lower than the equivalent rates of income tax, creates an incentive to recharacterize and convert income (e.g. from employment or a trade) into a business asset and then realize the value through a share sale.

The consequences of the above mean that there are strong incentives to use the CGT regime and the exemptions it affords taxpayers to minimize their tax liabilities. Compliance for CGT is also onerous for HMRC and the raft of anti-avoidance provisions which are necessary to secure the remaining income tax base is substantial, add to the complexity of the tax system.

TaxWatch suggests the CGT regime needs quite significant reform to re-target or remove exemptions, so the base is wider and more reflective of assets that taxpayers hold at a gain. This would potentially raise revenue as well as simplifying the tax regime, reducing the compliance cost for HMRC. Specifically, we would recommend the following:

1.1.1 Business Asset Disposal Relief

Option 1. Abolish Business Asset Disposal relief (BADR). It is not fit for purpose and has no economic value. An evaluation of its predecessor scheme, Entrepreneurs' Relief, described it as "costly, ineffective and not value for money"[1]. As a result of this evaluation the lifetime allowance was reduced, saving the Treasury "£1.6 billion in 2021-22 alone"[2]. However, the successor scheme bears all the hallmarks of the previous scheme and should be scrapped.

Option 2. If the abolition of BADR is not possible or politically desirable then substantial reform is necessary to reduce the exploitation of the current rules, and limit relief to those entrepreneurs who have either taken risks or built up a business. This would involve:

- Increasing the holding period required to qualify for relief. The current holding period is inappropriately short at just 24 months, and should be materially extended, for example to 5 years.
- Increasing the minimum shareholding requirement. The current rules only require an individual to hold a 5% interest in the company to qualify. This should be much higher, for example a controlling (>50%) shareholding, to limit the benefit to the principal shareholder.
- If the main rates of CGT are increased, the 10% rate currently afforded to BADR also needs to increase (the first £1m of gain is taxed at 10%) to avoid increasing the disparity between rates, making the relief even more attractive and open to abuse.

1.1.2 Miscellaneous exemptions

Remove CGT exemptions for UK gilts and assets such as classic cars and antique machinery such as clocks and watches. There is no economic reason for these exemptions and such sales should contribute to the annual exemption/be chargeable to CGT at the marginal rates reportable via CGT returns.

1.1.3 CGT tax rates

Align CGT tax rates broadly with rates of income tax charged on employment earnings and property income to reduce the incentives for tax motivated incorporation. This is only likely to be revenue raising once the tax base has been broadened adequately by

[1] Tax measures to encourage economic growth - NAO press release

[2] Tax measures to encourage economic growth - NAO press release

removing the exemptions suggested above, and we note that, on its unreformed base, a CGT rate increase is scored as a redbook net negative (i.e. cost) by the OBR in the costings document published within the election period due to the anticipated forestalling/deferral of sales by taxpayers likely to be caught by such an announcement.

Consult on the reintroduction of an indexation allowance to improve the incentives to hold assets for longer periods, reducing the tax payable where gains are largely inflationary once the rates of tax have been harmonized with income tax rates. This will help with the disincentive that CGT has at the margins for investors in productive assets intended to be held in the longer term/during periods where inflation is high, for example investments into commercial property which are ordinarily held for 15 or more years.

1.2 Inheritance Tax

Inheritance Tax (IHT) is the only tax on intergenerational wealth transfers within the UK fiscal regime and has significant implications for estate planning and trusts for wealthier individuals.

There is currently substantial debate around the future of IHT and the options for reform. TaxWatch follows these different proposals and offers its own perspective based on the following observations:

1) IHT has a very narrow tax base. The number of estates within the scope of IHT (whilst expected to grow substantially in the next 10 years) is currently very limited, with only 4.4% of UK deaths resulting in an IHT charge in 2021-22[3]. This is primarily a direct consequence of exemption thresholds, particularly those relating to spouses and civil partners, which allow many couples to pass on up to £1 million tax-free.
2) IHT includes several generous and uncapped reliefs. These remove whole classes of assets typically owned by wealthier households, and act as a distorting incentive for estate planning.
3) IHT is charged at a high rate. Taxing estates at 40%, above the main threshold and for assets not covered by reliefs, means there is a major incentive to avoid the tax.

The result of these factors is hard to manage compliance for HMRC, with a small number of very valuable IHT cases with significant tax risk associated with them.

To improve the functionality of the tax regime overall TaxWatch supports proposals offered by other commentators working in the field that seek to widen the base of IHT, primarily by reducing the proportionate generosity of key reliefs. Such changes would improve compliance and be less distortive to taxpayers (treating them more equally than the current regime depending on the type of assets their wealth has been invested

[3] Inheritance Tax liabilities statistics: commentary - GOV.UK (www.gov.uk)

in). This could either be used to increase revenue overall, or ‘spent’ to reduce the headline IHT rate as part of a package of measures.

1.2.1 Business and Agricultural relief

Option 1. Abolish both Business and Agricultural reliefs. The current regime of exemptions for IHT helps the wealthiest avoid IHT, whilst the bulk of estates pay marginal rates of tax far less than the 40% envisioned. Two of these exemptions are for agricultural land and qualifying business assets. Both could easily and quickly be removed.

Option 2. Place a limit on the amount of relief that can be claimed. They could be capped at a certain level, limiting the ability of wealthy individuals passing their wealth down without any IHT. The IFS have suggested that a cap could be set at £500,000 per person, which could be transferrable between spouses/civil partners. The result being that a couple could pass on a farm or business worth up to £1 million with no IHT liability.

Administratively, the introduction of a cap would introduce the need to check the valuation of businesses and farms to ascertain any proportion of these assets that would fall out, with a limited relief in calculating the Death Estate. This would inevitably increase the compliance workload of HMRC which makes this option less desirable than Option 1 above. Whilst the valuation of unlisted shares is commonplace but is also liable to interpretation and differences of opinion, and would increase the implications for executers and administrators of probate cases. This in turn would lead to HMRC spending more time and energy in compliance issues around valuations – the resource implications need to be fully costed into the yield forecast, additional to the HMRC Resource Departmental Expenditure Limits (RDEL) baseline.

1.2.2 Unquoted shares in AIM listings and other international stock exchanges

Remove the exemption on AIM listed shares, and other overseas stock exchanges. There is no rationale for retaining this exemption and it distorts the valuation of companies whose shares are marketed for their tax status rather than the underlying return to the investor. It does not apply to shares in ‘family businesses’, which are unlisted and illiquid/infrequently traded. This inevitably has an impact on the investment choices of those wishing to pass on assets, distorting economic decision-making. Again, this exemption could be removed quickly and easily.

1.2.3 Defined Contribution pensions

Remove the exemption for funds invested through defined contribution pensions. This merely creates another means of avoiding tax for wealthy individuals, who increasingly use pension pots as a means of avoiding IHT, rather than as a fund for their retirement. This is especially the case given the removal of the requirement to annuitise funds, with flexible drawdown arrangements and the various Income Tax and CGT advantages that are afforded to investments into pension schemes.

1.2.4 Offshore pensions such as QNUPs

The tax exempt status of pensions including/especially those operated offshore has driven quite blatant promotion and marketing of QNUPs (qualifying non-UK Pension Schemes) within the Ultra High Net Worth investor community - which is increasingly sold as a means of avoiding CGT and IHT, rather than as a pension vehicle[4].

Given the closure of final salary pension schemes this asset class is expected to grow very considerably in the next few decades. Making the change would reduce the distortions taxpayers experience in funding their retirement.

1.2.5 Uplift on asset values for CGT on death

Remove the uplift on base costs on death. A significant issue with IHT is how it interacts with CGT where a donor bequeaths an asset on death which is later sold by the donee. Currently the donee inherits the asset at its market value at the date of probate, i.e. its historic cost is inflated by the proportion of the unrealised gain during the ownership period of the donor. This creates an incentive for assets standing at a significant gain to be held until death to remove the charge to CGT. It would improve tax policy design and raise additional revenue if this flaw was fixed, so that the donee inherits the base cost of the asset from the donor and if the asset is subsequently sold at a gain by the donee then they are liable to CGT on the higher gain, if the asset is chargeable.

1.2.6 Extended time to settle IHT

Increase the timescale for payment of IHT. The requirement to pay IHT six months after death causes many beneficiaries financial problems due to the length of time probate is currently taking, on average 9-12 months. The process takes even longer where no will is in place as an administrator is required to be appointed.

To alleviate this growing problem, TaxWatch recommends that the date by which IHT must be paid is changed to enable probate or grant of letters to be given, together with a reasonable time period for the executors/administrators of the estate to dispose of assets required to pay the IHT. We recommend a period of 3 months following the grant of probate.

1.2.7 Nil Rate Bands

Within IHT we now have two Nil Rate Bands shielding lower value death estates from the tax. The main Nil Rate Band (NRB) has been set at £325,000 since April 2009. This was supplemented from 2017 onwards with an additional Residence Nil Rate Band (RNRB) which only applies where the death estate includes the main home of the deceased taxpayer and the bequest is to their direct descendent, and worth (up to) £175,000. There are very complex rules about how to apportion the RNRB if only part of the bequest qualifies for it, and the effect of a taper for estates over £2,000,000 at the

[4] Super-rich being advised how to avoid Labour tax clampdown, undercover investigation suggests | Tax avoidance | The Guardian

date of death of the first spouse makes it yet more difficult for executers to comply and file the IHT return free of error.

There are very significant geographical inequalities with the concept behind the RNRB. It favours taxpayers who have wealth tied up in housing (vs other assets) as the unused RNRB cannot be applied against the wider estate assets. Given housing wealth distribution across the UK, it is predominantly used by estates located in London and the South-East England and undermines intergenerational equity.

Having both bands operating together also makes compliance harder for the executers appointed by the will, and the relationship between the deceased and the recipient of the asset under probate makes no economic sense and has compliance impacts. To illustrate the complexity of the rules around the RNRB, and the interaction with other parts of the probate and IHT regime the length of the guidance on gov.uk is illuminating[5].

In order to remedy these issues it would make policy sense to collapse the RNRB into an expanded main NRB applicable for all estates, set at £500,000 whether or not this band is uprated periodically for inflation. This would reduce the compliance resourcing requirement for HMRC and free up these officers to focus on related complex issues where more revenue is at risk. The Tax Gap for IHT is estimated at 4.4% in 2022-23 and characterised by 'a small number of very high yielding compliance cases and a large number of low yielding cases'[6].

1.2.8 Rates of IHT

Assuming the above reforms have been considered and enacted, there might be a desire to consult on variable rates of IHT, rather than a flat 40% (except for the reduced rate of 36% for death estates bequeathing a proportion to registered charities) rate of IHT regardless of the size of the death estate.

A tiered regime, with lower rates of tax for smaller estates above the NRB and higher rates on very large estates would ensure IHT is at least not regressive across the wealth deciles[7]. However such a move would come at a revenue cost and would require consultation to ensure unintended consequences are managed appropriately.

---

[5] Work out and apply the residence nil rate band for Inheritance Tax - GOV.UK (www.gov.uk)

[6] https://www.gov.uk/government/statistics/measuring-tax-gaps/6-tax-gaps-other-taxes#inheritance-tax

[7] This is because gifts out of ordinary income, and lifetime gifts made where the donor survives 3-7+ years will continue to allow wealthier families to reduce the value of their estate in the years approaching death and would be administratively difficult (before the political currency issues are factored in) to remove.

1.2.9 Other proposed reforms

Other reforms to IHT that have been mooted have significant compliance implications that need to be considered, as they would actually entail major reforms:

Amongst these suggestions is shifting the burden of IHT from the donor to donee. This is commonly used internationally and does have advantages, such as being more progressive, taking account of the beneficiaries' income and wealth and reducing opportunities for avoidance. However, the shift requires additional documentation, which may prove burdensome on HMRC, including the need to track lifetime gifts (so look back and record keeping obligations) and the obligation to file an IHT return per donee alongside one for the deceased estate (similar to partners within a traditional partnership are required to file a partnership return alongside a self assessment tax return per partner).

There are complex arguments within the practitioner community surrounding the reforms to domicile and residence for trusts in relation to IHT. TaxWatch consciously doesn't offer specific comment on these issues as it's an area we don't feel competent to take a view on.

2 Taxes on personal income

2.1 Income Tax

There are a few income tax aspects that entail significant compliance and tax policy design implications that need thinking through when deciding the future of income tax.

2.1.1 High Income Child Benefit Income Charge

On the 'what not to do to make the situation worse' front, the High Income Child Benefit Income Charge (HICBIC) leads the pack, where the higher earning parent taxpayer loses a proportionate share of child benefit claimed for their children when their adjusted net income is above £60,000 with complete clawback beyond net income of £80,000.

Whilst this is a gentler clawback than previously the case before Spring Budget, there remains a high marginal tax rate for parents of larger families. Compliance wise it catches many families unaware as it requires completion of a self assessment tax return where otherwise the taxpayer is likely to be within the PAYE system. It has also triggered a slew of tax tribunal cases for multiple tax years where the parent hasn't filed the necessary tax return and paid the HICBIC (often for multiple years).

Option 1. Abolish HICBIC altogether. This would remove the high marginal tax rates on those with large families (especially those with a main/sole earner) and simplify the tax system, removing many people from Self-Assessment.

Option 2. Do nothing. Make no changes to the current rules but improve alignment between PAYE systems and DWP's Child Benefit system to alert taxpayers to their potential liability and prompt them to take action before too much debt is accrued. HMRC have recently been issuing One-To-Many letters encouraging taxpayers who have claimed Child Benefit but not filed a self assessment tax return to account for HICBIC to review their position – this is a small positive step that HMRC are becoming more pro-active in taxpayer education to improve compliance.

Do not introduce a household basis of taxation for HICBIC. The absolute worst thing the new Government could do would be to try to move this one part of the tax system onto the household basis of taxation as none of HMRC's systems currently operate in this way.

2.1.2 Abolition of the Furnished holiday lettings regime

TaxWatch wrote a report on this last summer when we exposed the abuse of the regime by second homeowners for income and capital gains tax purposes and suggested its abolition. We therefore agree with its abolition, and welcome the recent announcement that this will be legislated in the upcoming Finance Bill following confirmation in the Autumn Statement. This is especially timely given recent statistics show the increasing income declared as being received for owners of unincorporated FHL in 2022/23 of over £17,600 on average[8].

2.1.3 Income tax rates

Align the tax rates on dividends with other sources of income. Whilst manifesto commitments on the main rates of basic, higher and additional rates for workers curtail options here, we think that the rates of income tax charged on dividend income are not affected by this commitment and are ripe for alignment.

There are benefits in terms of revenue raising, although not enormous amounts. The main reasons why its recommended are:

1) It removes a large incentive for tax motivated incorporation, where small businesses incorporate to pay small salaries via PAYE to secure the NI credit and the remainder in large dividends to reduce their overall tax 'burden'.
2) It would be quick and easy to legislate for, e.g. from Budget Day to capture dividends with immediate effect and reduce scope for tax planning which would otherwise depress revenue yield in the first year.
3) On the basis of equity, £1 of dividends being worth the same in the hands of the recipient as £1 of earned income from employment or £1 of property/trading profit.

[8] https://www.gov.uk/government/statistics/property-rental-income-statistics/property-rental-income-statistics-2024

4) It almost completely unwinds the tax motivated incorporation incentive which contributes to disproportionate numbers of micro small companies registered at Companies House who have no employees other than the principal shareholder and their direct family.
5) Taxpayers making most use of this structuring are proportionately clustered in higher income deciles of the population, more likely to have a tax adviser, and the savings are large in many cases.

If the Government wanted to manage the impact for small shareholder investors, one approach is to put the Dividend Allowance up (currently only £500pa so increasing this back to its recent £2,000pa level would be affordable overall).

2.1.4 Savings income

Income tax on relatively small amounts of savings income has become unnecessarily complex with the Personal Savings Allowance, which varies according to an individual's highest marginal rate of tax, and the Starting Rate for Savings which is tapered after reaching an income level of £17,570.

For most taxpayers this is a level of complexity that they can't cope with unless they have an adviser, so in many instances the Starting Rate for Savers goes unclaimed. We suggest it is abolished.

The Personal Savings Allowance rates were set when interest rates were at historic lows and haven't been adjusted since, and the random cliff edge when it falls by half, and then disappears entirely is very poor policy design as it contributes to very sharp marginal tax rates which are not obvious. The £1,000 limit should be inflation pegged and available to all taxpayers.

For compliance purposes the fact that saving income is now paid to the recipient without the deduction of basic rate income tax, requires taxpayers above their Personal Savings Allowance to register for self assessment or an adjustment to their tax code on earned or pension income to account for and pay the income tax due. There is confusion amongst taxpayers about who needs to participate in self assessment, with the online tool only asking if savings income exceeds £10,000[9].

2.1.5 National Insurance

The previous Conservative Government made quite a few changes to NIC rates, prioritising cuts to employee (Class 1 Primary) and self-employed (Class 4, Class 2 being abolished) rates. Differences in the national insurance payable between different forms of work are a huge contributor to compliance issues including the 'IR35'/disguised remuneration avoidance scheme promoters and the retrospective fix coined the 'Loan Charge'.

---

[9] Check if you need to send a Self Assessment tax return - GOV.UK (www.gov.uk)

Bringing Class 4 and Class 1 Primary rates into closer alignment won't solve the main issue because Class 1 Secondary contributions paid by the employer are the major wedge between employment and self-employment. However, as the public finances allow, reductions in the Class 1 primary rates would have a marginal positive impact on disguised employment incentives and improve compliance. IR35 intermediary legislation is critical to maintain as, whilst disliked, it is doing a lot of heavy lifting in the regime overall.

Radical idea: Merge National Insurance for employees and the self-employed with income tax, creating easy to understand, single rates of tax for all sources of income received by an individual taxpayer. This is understandably very complex from a political standpoint but has much to commend it economically and in terms of tax design. Employer NI (Class 1 Secondary) could then be reformulated into a specific payroll tax following consultation with employers, payroll software providers and business representative organisations.

3 Business Taxation

3.1 Corporation Tax

Having committed to maintain the headline rate at 25% unless there is a competitiveness challenge, there is much less room for manoeuvre for the majority of business taxation.

3.1.1 Small profits rate

Abolish the small profits rate of corporation tax. In terms of simplification, the re-introduction by the Conservative Government of a small profits rate for the smallest companies made little economic or compliance sense as there are now a very complicated rules to determine which side of the line profits in each year are, and to prevent artificial fragmentation.

From a simplification perspective it would make more sense to harmonise the rate. This would not raise much revenue as the amount of profits that secure the benefit of the 6 point reduced rate is set extraordinarily low, at £50k each. Most of these companies are only incorporated business forms for tax planning and cash extraction. Tax motivated incorporation is a real factor in the UK, and to reduce this would be sensible tax policy.

3.1.2 Tax incentives for companies

Tax is one lever that is available to government to promote beneficial behaviours, but not the only one. The problem with using the tax system to incentivise specific

behaviours is that it creates additional work for HMRC in terms of administration and compliance. As recent issues with the R&D tax credit for small companies also demonstrates, they are commonly open to abuse[10] and result in significant loss of tax revenues[11].

We note that there have been suggestions related to the potential introduction of a 'green innovation credit' modelled on the film and high-end television credits and the Patent Box. We would warn against the introduction of such schemes due to the problems created by incentivising specific behaviours and the unintended outcomes of doing so.

3.1.3 Creative industry tax reliefs

In addition to the R&D tax credits, an ever-increasing amount of tax credits are being claimed by creative industries. Whilst the tax credits bring much needed investment to the UK, boosting the economy, there is concern that large multinational companies are exploiting the talent in the UK, at the taxpayer's expense. Particularly where very successful and profitable films and television programmes are made in the UK, but none of the profits related to them remain in the UK to be taxed.

Our own research shows that large studios are claiming huge amounts of film and television tax credits on very profitable films and television programmes, whilst paying no corporation tax on the profits in the UK[12]. This is a major design problem as the credit is a multiple of the qualifying expenditure thus incentivising cost escalation and companies trying to claim for ineligible costs or buying services from related parties at a price that is not at arms length. We know that the dedicated Creative Industries unit within HMRC is extremely small with little risk of enquiries being conducted into claims.

Based on our review of the existing system, we would recommend the following changes:

Cap the total Creative Industry Expenditure Credits per production. 'High value claims' for Television (claims of more than £2m) and Film Tax Credit (more than £10m) now account for the vast majority of claims. For Film Tax Credits, high value claims accounted for less than 2% of total claims in 2022-23 (15 out of 895 claims), but 53% of the total amount paid. For High End Television tax credits claims exceeding £2m accounted for more than 80% of the total amount paid in 2021-22 [13].

The total amount of High End Television relief has rocketed in recent years, reaching a provisional total of over £1.1bn in 2022-23, double that of film tax relief (£553m) which has also grown strongly since the covid pandemic. HMRC statistics on the amounts of relief claimed are revised upwards from year to year, with some dramatic revisions following an under-estimation of claims made. For example, the total amount of high

---

[10] Green Jellyfish - fraudulent R&D tax relief claims (taxpolicy.org.uk)

[11] Persistent large scale error and fraud in SME R&D relief – TaxWatch (taxwatchuk.org)

[12] No Time To Pay Tax? – TaxWatch (taxwatchuk.org)

[13] Creative industries statistics commentary: August 2023 - GOV.UK (www.gov.uk)

end TV relief for 2021-22 which originally estimated to be £829m, only to be revised up to £982m just 12 months later – an increase of 18.5%.

It's unclear whether there is insufficient focus on these reliefs (so the estimates are poor), or whether the team have all the information they need, nearly 17 months after the end of the tax year for which the claim relates, to have a good handle on the costs. But there is pressure on the team within HMRC responsible for the release to understate the cost given recent Treasury Select Committee scrutiny[14] of these incentives (to which TaxWatch provided evidence). Either way, the cost of the incentives are eye wateringly expensive with extremely low levels of public scrutiny and the regime has recently been made yet more generous via changes made under Chancellor Hunt which we'd recommend are reviewed.

If these reliefs are maintained in a similar form to the previous regime, rather than being substantially reformed to control costs, TaxWatch would encourage the new Government to place a cap on the amount of tax credits that can be claimed on a single film or television series. This would help ensure that the incentives are targeted to lower budget claims rather than very large claims being granted to a few blockbuster franchises. We don't have enough distributional information to see the spread of claims beyond the overly broad HMRC statistics categories[15], but a cap of £5m for a single film and £1m for a TV episode would appear to be appropriate.

Tighten the 'British Cultural' Test. The 'British Cultural' test administered by BFI is far too loose and allows all sorts of films and video games that have dubious British cultural value, e.g. the Grand Theft Auto video game series and Marvel's Avengers films. To ensure that there is some cultural value to the test it needs to be tightened significantly.

Tighten compliance procedures between HMRC and BFI to ensure that credits get recouped if final certification is not in place. Creative industry tax credits can only be claimed by a production with a final certification of Britishness. Before final certification is awarded, interim certification is awarded such that tax credits can be claimed. However, it is vital for the integrity of the tax regime that, where final certification is not granted, any and all tax credits claimed are clawed back by HMRC. This requires better compliance procedures and communication between BFI and HMRC.

Improve the transparency around the claiming of tax credits. Under EU rules, aid given to companies must be transparent. In this respect, claimants of creative industry tax credits are included in a publicly available list produced by the EU. As we have now left the EU, companies claiming credits in the UK are no longer visible in any form. We believe there should be transparency where such large sums of taxpayers' money are being given away, and we have the right to know to whom our money is being given. We therefore recommend the establishment of a publicly available list of companies claiming creative industry tax reliefs.

---

[14] 'Our tax system is too complicated' concludes Treasury Committee… – TaxWatch (taxwatchuk.org)

[15] https://www.gov.uk/government/statistics/creative-industries-statistics-august-2024

3.1.4 CT relief for charitable donations

One of the few areas where UK resident companies secure Corporation Tax relief for payments that are not incurred 'wholly and exclusively for the purposes of the trade' is donations to (UK registered) charities. Charitable giving via other methods (payroll giving, Gift Aid etc) is well established and provides a targeted incentive to increase funds to good causes.

The relief for UK Corporation Tax purposes for charitable donations is less clear in policy terms. TaxWatch have recently become aware of a case with a very profitable and well-known corporate group whose owners have established a charitable foundation, controlled by the company directors, and shovelled over £730 million of profits over the last 10 years that would otherwise be chargeable to CT into the foundation. For the most part those funds remain unspent in the foundation. The foundation concerned received no income from any other donors throughout the period (whereas most charities are seeking to diversify their income sources and funders over time). This has accelerated CT relief for a decade and appears to be tax motivated. There is a lack of oversight by The Charities Commission about related foundations and their receipts from UK companies where the trustees and directors are the same.

There are no published HMRC Statistics to summarise how much Corporation Tax relief is being claimed for charity donations and which groups are making use of this more minor relief.

Option 1: Abolish UK Corporation Tax relief for charitable donations altogether with renewed communications to publicise the Gift Aid and Payroll giving schemes for company employees and individual shareholders.

Option 2: UK Corporation Tax relief for charitable donations is restricted for donations where there is a connected party between the charity trustee and the company director/shareholder. Charitable donations would only be eligible for relief to the extent the funds have been distributed by the connected charity within 12 months of the donation being made. This would be more cumbersome as The Charities Commission and Companies House IT systems are thought to be operationally separate, and there is suboptimal oversight on charitable fund balances held by charities by The Charities Commission.

3.1.5 Finance costs for companies

For Corporation Tax purposes most UK companies secure a full deduction for their total amount of financing expenses in the year they are incurred. Whereas (correctly) no relief for equity returns is allowed within the regime. The ultimate effect of this is that there is a preference within our tax regime for companies to finance their expansion and growth via taking on corporate debt for which a CT deduction is available. When interest rates on that debt rise it can cause severe gearing and liquidity issues which hamper

growth. There is a large number of overlapping anti-avoidance measures designed to ensure amounts of relief for debt finance are not excessive, such as corporate interest restriction, transfer pricing thin capitalisation and hybrid mismatch rules. There is also considerable case law interpreting 'unallowable purpose' rules such as the recent Blackstone judgement. Finally, there is the General Anti Abuse Rule (GAAR) designed to catch arrangements which have insufficient commercial basis.

Following the introduction of full expensing for plant and machinery investments in 2023, we now give effective relief for almost all business costs including capital expenditure, as well as relief for the financing costs. From an economic perspective this has been flagged by commentators such as the IFS as deeply distortionary. There are also major compliance and avoidance implications for permitting this to continue.

Whilst it would be a radical change we would encourage the new Government to consult on removing Corporation Tax relief for finance costs in exchange for a lower rate of Corporation Tax on a revenue neutral basis. This would have distributional impacts between sectors as highly leveraged companies would suffer a slightly higher corporation tax burden, and low/no debt companies would benefit compared. However the main benefit of such a change is that there would be a wholesale rationalisation of the UK tax code and this would also reduce the compliance caseload within HMRC and the number of cases going through dispute resolution and the courts and tribunals service in the future.

This would mirror the change made within the oil ringfence regime where finance costs are not allowable for the purposes of Supplementary Charge or the Energy Profits Levy.

3.1.6 VAT

Cliff edges in taxation are never a good thing. All too often they influence behaviour and result in behaviours that would otherwise not occur. The current threshold for VAT registration in the UK is a prime example of this.

The threshold in the UK is amongst the highest in the OECD[16]. There is significant evidence that the threshold, above which businesses would have to charge 20% VAT on their goods and services, has a 'bunching' effect of businesses with reporting revenues just below the VAT threshold[17]. As the Office of Tax Simplification highlighted, this is the result of two business practices. The first is the deliberate limiting of revenues to avoid breaching the threshold, the second is under-reporting of revenues[18]. The first practice very much contradicts Labour's pro-growth strategy. The second exacerbates the tax gap that Labour has pledged to combat. We would therefore suggest the following:

[16] https://www.oecd.org/tax/consumption/vat-gst-annual-turnover-concessions-ctt-trends.xlsx
[17] wp631.2022.pdf (warwick.ac.uk)
[18] Value added tax: routes to simplification (publishing.service.gov.uk)

Reduce the threshold to a much lower figure, for example £15-20,000 per annum. This would bring virtually all businesses within the scope of VAT. The reduction could be accompanied by the introduction of a 'smoothing mechanism', for example a sliding scale of VAT for smaller businesses from 0% - 20%, applied to both input and output VAT. Such a move would remove the current cliff edge that restricts growth and encourages tax evasion through the non-reporting of income. Such a move would also require the simplification and automation of much of the VAT compliance process. Whilst Make Tax Digital is addressing this issue, more still needs to be done to ensure that financial costs and administrative burdens are kept to a minimum, especially for small businesses[19].

4 Pension tax relief

Option 1. Limit pension income tax relief to the basic rate of 20%. This would simplify the tax regime around pensions and raise additional revenue. This would restrict the benefits of contributing to a pension for higher earners and constitute a significant cost saving for the Treasury.

It would remove a significant number of higher rate taxpayers from the scope of self-assessment as they only complete a tax return to claim pensions tax relief so a compliance benefit. There would also be a simplification benefit as the complex rules determining how much of any contributions qualify for tax relief which could be swept away if all contributions are capped at the basic rate. There is a certainty and predictability benefit if the proportion of relief is fixed and stable which helps taxpayers understand the complicated pensions landscape.

Option 2. There is an alternative, to recycle a proportion of the revenues raised in the lead suggestion if it would be politically difficult or if there was a desire to redistribute the benefits to a greater extent. This would be to grant an additional 5 percentage points of tax relief for all taxpayers, so those within the basic rate would get a higher proportion of relief for contributions (helping them save more as the evidence shows that lower income households structurally underprovide for their retirement) whereas those paying income tax as the higher or additional rate would secure less relief, encouraging wealthier households to consider alternative investments.

Option 3. Under current rules, payments out of a pension are chargeable to income tax at the taxpayer's marginal rate above a proportion (currently 25%) which can be taken out free of tax. Given the current lifetime limit of over £1m this permits the largest pots to benefit from over £250,000 to be free of income tax per pensioner. Limiting this tax free lump sum amount (e.g. the first £100,000) would reduce the benefit for the richest pensioners. Alternatively, the 25% proportion could be revised down to 20% or below. Either change would have distributional impacts, the first being more progressive, the second being more neutral affecting defined contribution pension pots irrespective of size.

---

[19] Making Tax Digital: Early impact on VAT below threshold customers - GOV.UK (www.gov.uk)

Option 4. Review the NIC treatment of pension contributions and/or payments. Currently contributions into occupational pension schemes are granted NIC relief at source as they are paid in from gross earnings prior to Class 1 Primary and Secondary contributions, despite the fact that there is no NIC on the payments out of pensions in retirement. This further advantages the tax treatment of pensions, and in the case of occupational pensions this appears to be particularly over-generous.

If the Government wanted to adjust this there would be two discrete options:

a) Deny NIC relief for employer and employee payments into occupational pensions to align them with personal pensions (used predominantly by the self employed). This would reduce the benefit of paying into a pension at the margin, but with other retirement investment options available (lifetime ISAs, SIPPs, share schemes etc.) this would re-calibrate the options for higher earning employees. OR
b) Charge payments out of occupational pension schemes to NIC Class 1 Primary for the retiree (above the current lower earnings threshold) which would secure additional tax revenues from those with the largest occupational pensions, but have much less impact on those with more modest occupational pension schemes. The pension administrator could administer the NIC deductions on behalf of scheme participants thus avoiding individuals having to enter self assessment.

5 Conclusion

This Budget Representation has been focussed on areas where the tax regime creates or exacerbates distortions that make compliance less likely and more costly to police, but also holds back the UK economy. With the new Government focussed on growth there are wide ranging areas of tax reform needed, and some of this will be longer term, through the current Parliament and beyond.

Prior to its abolition the Office for Tax Simplification was a useful arm's length body to consider the tax regime holistically and recommend change. We would welcome a similar body being set up, tasked with an explicit mandate to focus on areas where tax reform could drive productivity – a Fiscal Growth Commission.

Summary for portal: (250 words max)

TaxWatch recommends changes across the UK fiscal regime to address distorting incentives between taxpayers which hold back growth, depress Government revenues and which complicates compliance, adding to HMRC's resource burden. Our representation attempts to take a holistic view, and considers the interaction between taxes and implications for vertical and horizontal equity.