

Budget 2006: Regulatory Impact Assessments

March 2006



HM TREASURY



HM Revenue
& Customs

Budget 2006:
Regulatory Impact Assessments

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REGULATORY IMPACT ASSESSMENT FOR CHANGES TO THE CORPORATION TAX STRUCTURE

Introduction

1.1 The Government will replace the non-corporate distribution rate and the starting rate of corporation tax with a single small companies' rate.

1.2 This Full RIA updates the Partial version published alongside the December 2005 Pre-Budget Report.

Purpose and Intended Effects of the Measure

The Policy Objectives

1.3 The Government's objectives for the business tax system are that it should promote productivity and growth by supporting business competitiveness, while ensuring business contributes its fair share to the funding of public services. This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their businesses.

1.4 Existing incentives for growth have had some success in encouraging small companies to reinvest their profits. However, the benefits of existing incentives are being eroded by increasing numbers of new incorporations, who do not have growth ambitions, but are still able to take advantage of these incentives. The Government's objective is to refocus growth incentives so that the support for and benefits of reinvestment go to businesses with growth ambitions and it is concerned that any incentives should be perceived as fair. Use of the incentives by people being encouraged to incorporate and reduce their tax and national insurance contributions (NICs) liability erodes that fairness

Background

1.5 A range of measures has been introduced by the Government to support small businesses, including reductions in both income tax and corporation tax, and payable tax credits for research and development.

1.6 The starting rate of corporation tax was introduced in 2000 and reduced from 10 per cent to zero per cent in 2002. It applied to companies with profits up to £10,000 per year. Marginal relief was also introduced for companies with profits between £10,000 and £50,000 per year. Above this level, profits were taxed at the small companies' rate of 19 per cent (up to a threshold of £300,000).

1.7 After the reduction of the starting rate to zero per cent, concerns were raised that the benefits of the rate were being used by incorporations not intending to grow. Therefore, at Budget 2004 the 'non-corporate distribution rate' (NCDR) was introduced to ensure the incentive was focused on profits retained by small companies. The NCDR charged 19 per cent on any profits distributed as dividend payments to individuals, rather than retained in the company to fund investment.

1.8 Alongside the 2004 Pre-Budget Report (PBR), the Government published a discussion paper, *Small companies, the self-employed and the tax system* to stimulate debate on how the taxation structure for small businesses could be further improved. A

majority of responses (both directly to the discussion paper and in meetings) requested simplification of the corporation tax structure for small companies. There was also agreement that the zero per cent starting rate of corporation tax, while providing an opportunity for small companies to retain their profits, had led to unfair tax outcomes in comparison with sole traders/partnerships.

Rationale for Government Intervention

1.9 Simplification of the corporation tax structure for small companies allows them to focus on growing their businesses and increasing their profits by reducing their administrative burden. The Government believes that the growth of small businesses is essential for providing flexibility and dynamism in the UK economy. As well as providing innovations and efficiency gains of their own, new businesses with growth potential present a strong competitive challenge to incumbent firms, who are in turn prompted to improve productivity.

1.10 Although the starting rate offers tax advantages for firms that retain their profits rather than distributing them, it also offers tax savings to companies with no intention of growing. Another rationale for change is therefore to better target this support to firms that have growth aspirations and that are investing. The Government is also concerned that the integrity of the tax system is undermined when the incentives are perceived to result in unfairness.

Consultation

1.11 As mentioned above, the Government issued a discussion paper alongside PBR 2004 to gauge the views of business on how the tax and incentive structure should operate. At Budget 2005 it was announced that the closing date for responses to the discussion paper would be 29 April 2005. By that stage more than 30 responses had been received including from the Confederation of British Industry, Federation of Small Businesses, Small Business Service, and others. Officials in both HM Revenue and Customs and HM Treasury have continued to engage in informal dialogue with business representatives.

1.12 The responses to the discussion paper raised a wide range of issues, but there was no consensus on future developments. The key issues raised were the need for simplicity and certainty in the taxation of small business.

1.13 At PBR 2005 the Government announced their intention to remove the zero per cent starting rate of corporation tax and the NCDR (option 3 below). A partial RIA was published, inviting comments particularly on the compliance costs of the starting rate and NCDR.

Options

1.14 Three options have been considered to simplify the corporation tax structure for small companies. **All changes would be effective from 1 April 2006.**

1. Do Nothing

1.15 If no changes are made, the number of the incorporations who benefit from the starting rate incentive for growth, but who are not intending to grow, would increase and the compliance costs identified by small companies in administering the NCDR would remain.

2. Remove the NCDR and leave the Starting Rate of Corporation Tax in place

1.16 This option would return the corporation tax structure to that which existed before the introduction of the NCDR in 2004. Although this would achieve a simplification of the structure, it would not improve the focusing of incentives on small companies intending to grow. There is also a large risk that further incorporations would take place by businesses which did not intend to retain and reinvest their profits for growth – thus increasing the unfairness of businesses exploiting the incentives simply to reduce their tax and NICs liability.

3. Remove both the NCDR and Starting Rate of Corporation Tax and provide Direct Incentives for Growth

1.17 Removing both the NCDR and the starting rate, and replacing them with a single small companies' rate, would achieve significant simplification of the corporation tax structure for small companies. It would also mean that companies with profits of less than £50,000 per year could have a tax increase, depending on their current profit distribution policy.

1.18 The corporation tax incentive to retain profits would be removed, so the Government proposes to focus incentives better so that both companies and sole-traders/partnerships can benefit more directly when they reinvest, rather than just retain their profits. The first year capital allowances available to small businesses will be increased from the current level of 40 per cent to 50 per cent for investment in plant and machinery made in the year from April 2006.

Costs and Benefits

Sectors and Groups Affected

1.19 Companies in all sectors are potentially affected. The impact will vary by profit level. The table below shows the number of companies affected, broken down by sector.

Table 1.1 Number of companies affected, broken down by sector

Sector	Number
Agriculture and Mining	10,500
Manufacturing	43,500
Technology	69,000
Utilities	500
Construction	72,500
Transport	34,500
Wholesale and Retail	64,000
Hotels, Bars and Catering	23,500
Finance and Real Estate	61,500
Business Services	221,000
Entertainment and Personal Care	61,000
Other	31,500
Not Known	27,000
Total	720,000

Financial Impacts

1.20 Each option would result in different amounts of overall tax (and NICs) paid to the Exchequer by small businesses depending on the legal form they adopt and hence the rates of tax (and NICs) due. The overall impact would also be affected by the numbers of businesses that incorporated because they thought they could gain a tax advantage by doing so.

1.21 The financial impacts would vary according to the profit level of the company. For example, a small company which made £20,000 per year from which it paid a salary to its owner manager of £10,000: under option 1, if its remaining profits (£10,000) were retained in the company then the company would pay no corporation tax (the zero per cent rate). If its profits were distributed they would be subject to the 19 per cent NCDR. The same company under option 2 would pay no tax (the zero per cent rate), whether its profits were retained in the company or distributed. Under option 3, it would pay the 19 per cent corporation tax whether its profits were retained in the company or distributed.

1.22 Another company with profits between £10,000 and £50,000 would be liable at the 19 per cent small companies' rate of corporation tax under option 1, with a reduction for marginal relief. If the profits were distributed, the company would, through the NCDR, pay tax at 19 per cent. The same company in the marginal relief band would under option 2 only pay the corporation tax with marginal relief. Under option 3 it would pay a single rate of 19 per cent corporation tax.

1.23 In total we estimate that 720,000 companies have profits under £50,000 per annum and so would be impacted by all options. This figure has been reduced from 820,000 in the partial RIA due to new and better company data. The amount of tax they would pay under each option depends on their profit level and whether or not they already paid NCDR. Not all companies who are liable to NCDR will have filed returns yet so detailed information is not available on the number already paying NCDR who would see little or no increase in tax under option 3. We estimate that the median tax increase for all companies under that option would be around £475 per year.

1.24 The benefit to businesses of the first year capital allowance under option 3 depends on their level of profits and legal form. For example a small company making a £1,000 investment in plant and machinery would gain £19 on profits taxed at 19 per cent and £30 where profits were taxed at 30 per cent. Around 4,200,000 small businesses would be eligible for the increased allowance as it is available to sole traders/partnerships as well as companies.

Compliance Costs

1. Do Nothing

1.25 The compliance costs identified by small companies in administering the NCDR – through identifying non-corporate dividends and calculating the NCDR – would remain. The RIA for the NCDR published in April 2004 estimated only a modest increase on the then existing compliance costs. However, discussions with small businesses and their representatives since publication of the discussion paper indicate that the compliance costs related to implementation of the NCDR were significantly greater than originally estimated.

1.26 Compliance costs are created because a company has to calculate the corporation tax which would be due if the NCDR did not exist, and thus establish the underlying rate of tax; establish the amount distributed through dividends to persons other than companies; apply the NCDR rate to that amount of non-corporate dividend; and apply an underlying rate to the balance of taxable profits. The partial RIA estimated these compliance costs to be in the region of £35 million per year. Responses to the partial RIA suggested that this figure over-estimated the time taken to complete the NCDR calculation. The figure on the number of companies affected by the NCDR has also been revised downwards to 310,000. The compliance costs associated with the NCDR are therefore calculated to be £23 million per year, assuming the total compliance time for a company to be 1.5 hours and that their time costs £50 per hour.

2. Remove the NCDR and leave the Starting Rate of Corporation Tax in place

1.27 Removal of the NCDR would provide deregulatory benefits to companies with profits below £50,000 per year as they would not be required to calculate the NCDR. Some complexity would remain for companies with profits between £10,000 and

£50,000 through having to calculate marginal relief on their corporation tax. The partial RIA estimated the cost of this complexity to be in the region of £10 million per year. As the number of companies affected has since then been revised downwards to 720,000, it is now calculated that the cost is £9 million, assuming it takes 0.25 hours at £50 an hour to calculate the marginal relief on their corporation tax.

3. Remove both the NCDR and Starting Rate of Corporation Tax and provide Direct Incentives for Growth

1.28 There would be significant deregulatory benefits obtained through the removal of the NCDR for companies with profits below £50,000 per year and the starting rate of corporation tax. As described above, it is estimated that this saving to business would be £23 million per year from removing the NCDR and £9 million from removing the starting rate. However, there would be a small additional cost for any companies with profits below £10,000 who are not currently distributing profits and so not liable for the NCDR.

1.29 In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Small Firms Impact Test

1.30 We estimate that nearly all of the impacts mentioned above will be on small and medium sized businesses. Corporation tax rates are based on profit levels not size of business, but at the level below £50,000 there is a strong correlation.

1.31 The Government will continue to seek the views of small businesses and their representatives on developments in the corporation tax structure and incentives for growth.

Competition Assessment

1.32 The competition filter test has been applied to this measure and no significant competition concerns have been identified.

1.33 The vast majority of firms affected by the change are small businesses that do not have any significant market share. The taxation paid by companies under the options would vary between companies, but the compliance costs would not. Simplification of the corporation tax structure will lead to lower ongoing compliance costs for new and existing companies.

1.34 Option 3 would help to level the competitive playing field as the incentives for growth would be available to all small businesses, in contrast to the zero per cent starting rate which was only available to companies.

Enforcement, Sanctions and Monitoring

1.35 Under option 1, the enforcement and monitoring costs from the NCDR as currently operated would continue. Options 2 and 3 would remove those costs.

1.36 Enforcement of compliance with the corporation tax regime generally is an integral part of HM Revenue and Customs administration of the UK tax system. Monitoring trends in re-investment by small businesses to determine where incentives may be best focussed is an ongoing activity of HM Treasury.

Summary and Recommendation

1.37 Taking account of the costs and benefits of the different options the Government takes the view that removing the NCDR and starting rate of corporation tax and increasing first year capital allowances to 50 per cent best meets the objective to better focus tax incentives for re-investment and to reduce administrative burdens on business by simplifying the corporation tax system.

Implementation and Delivery Plan

1.38 The removal of the NCDR and starting rate of corporation tax is a deregulatory measure and will simplify the corporation tax system for small companies. There will be no extra obligations on companies or requirements for data because of the measure.

1.39 The company tax return form and accompanying guide will be amended and new copies should be available in October 2006. Companies will have time to adjust to the new measure as the filing date for corporation tax is one year after the end of an accounting period. The earliest accounting period affected by the removal of the NCDR and starting rate of corporation tax will be that ending 1 April 2006. The filing date for this accounting period will be 1 April 2007. Guidance will be provided for all companies with accounting periods ending on or after 1 April 2006 so that companies affected by the changes and wanting to deliver their returns early can do so.

1.40 The guidance on the change will be provided for both small companies and their advisors. A Budget Insert giving advice, and describing the changes to company tax return forms and CT Online services, will be sent out with notices to deliver a company tax return. Paper copies of the Insert will be available from the order line. Further guidance will be published on the internet.

1.41 Neither the record keeping and business information requirements for the company tax return, nor the process for delivering returns, is affected by this measure.

1.42 The measure will also provide deregulatory benefits for Government because of the simplification of the corporation tax system. However, there will be a one-off cost from system changes, for example through changes to the company tax return form.

Post-implementation Review

1.43 The Government's objective is to simplify the corporation tax system and to better focus tax incentives for re-investment. They will monitor the impact of corporation tax simplification to assess whether further measures are necessary and monitor the take-up of first year capital allowances to assess the effectiveness of re-investment incentives.

1.44 The Government will continue to review the structure of the taxation systems to ensure that they are as simple as possible for compliant businesses, support businesses in their aspirations to grow, and maintain the overall competitiveness of UK business taxes.

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REGULATORY IMPACT ASSESSMENT

Changes to the Corporation Tax Structure

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

A handwritten signature in black ink, appearing to read 'John Healey', written over a light grey horizontal line.

John Healey
Financial Secretary to the Treasury

Dated: 16 March 2006

REGULATORY IMPACT ASSESSMENT FOR REAL ESTATE INVESTMENT TRUSTS (UK REITS)

Purpose and Intended Effects of the Measure

The Policy Objectives

2.1 This regulatory impact assessment considers a new measure to reform the tax treatment of property investment to:

- improve the quality and quantity of finance for investment in property,
- expand access to a wider range of savings products on a stable and well regulated basis,
- ensure that a fair level of taxation continues to be paid by the property sector, and
- support structural change in the property market.

Background

2.2 The 2003 Pre-Budget Report announced that in line with the interim recommendations of the Barker Review, the Government had concluded that reform to the tax treatment of property investment would improve liquidity, transparency and scrutiny of the property market, provide access to property for long-term savings, and could complement expansion of the private rented sector.

2.3 The Government published a consultation document at Budget 2004, 'Promoting more flexible investment in property: a consultation'¹, which included a partial regulatory impact assessment.

2.4 Based on the responses received to this consultation, the Government published a further discussion document at Budget 2005, 'UK Real Estate Investment Trusts: a discussion paper'², which addressed some outstanding technical issues and contained a summary of the responses to the 2004 consultation document.

2.5 Draft legislation to establish Real Estate Investment Trusts was published by HM Revenue and Customs on 14 December 2005, together with an updated partial Regulatory Impact Assessment and a summary of responses to the Budget 2005 Discussion Paper³. Further draft legislation setting out how the UK-REIT regime would apply to groups of companies was published on 27 January 2006, with a further updated partial Regulatory Impact Assessment⁴. A summary of consultation responses to both sets of legislation will be published by HM Revenue and Customs in due course.

2.6 It remains the opinion of the Government that introducing a bespoke property investment vehicle will bring economic benefits to the UK property investment market and the wider economy.

¹ http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm

² http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_odreits.cfm

³ <http://www.hmrc.gov.uk/drafts/estate-investment.htm>

⁴ http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageExcise_ShowContent&propertyType=document&columns=1&id=HMCE_PROD1_025090

Rationale for Government Intervention

2.7 The Government believes that there are a number of features of the property market that are resulting in it operating inefficiently, thereby reducing the full potential for productivity growth for the UK economy. These can be summarised as:

- **lack of choice for small investors** - who, if they want to access property returns, tend to do so in ways which involve a large relatively illiquid investment, such as buy-to-let investments or direct ownership. Access to this market is therefore restricted and the size of individual investments are such that investors cannot easily diversify their portfolio to reduce risk;
- **poor liquidity** - which is a reflection of the nature of property itself as an asset. The commercial property market is dominated by large investors and pricing and investment decisions are often determined by individual transactions among a small number of players;
- **potential for more efficient use of commercial property** - a high proportion of commercial property in the UK is owner occupied and this tends to be used less intensively than property in the investment market. More indirect investment would promote increased efficiency in the use of commercial property stock through economies of scale;
- **variable standards of provision in the private rented sector** - with wide variations in management efficiency. Improvements to this sector could enhance efficiency and flexibility in the housing market;
- **high levels of debt financing** - which increase the sector's sensitivity to interest rate changes and may lead to instability in the wider economy; and
- **tax distortions** - as investors are taxed differently, depending on how they invest in property, it is not easy to compare performance of different investment choices. This may result in investors undertaking more risky, less stable investments than if it were possible to make a simple and direct comparison.

2.8 The Government believes that the proposed vehicle addresses all of the above points by introducing more choice for small investors, allowing more liquidity in the market, giving potential for more efficiently and professionally managed property, reducing dependency on debt for financing and removing tax distortions. The Government remains committed to ensuring that any reform is introduced at no overall cost to the Exchequer.

2.9 Following responses received to the 2004 consultation, the Government will bring forward legislation to repeal sections 508A and 508B of the Income and Corporation Taxes Act 1988 which deal with Housing Investment Trusts.

Options

1. Do Nothing

2.10 Doing nothing would mean that the property market would continue to operate in a sub-optimal way. Similar vehicles have been established in at least 11 developed economies, showing that there is widespread recognition of the benefits of such a regime.

2. Alternative Solution

2.11 The Government is considering in parallel the tax treatment of alternative vehicles that might be seen as close substitutes for investing in property, such as open-ended collective investment schemes. The Government has also considered whether private vehicles should also be permitted to participate in the UK-REIT regime and has concluded that this would not deliver against the objective of encouraging wider investment from small investors.

3. Real Estate Investment Trusts

2.12 The Government is publishing legislation in Finance Bill 2006. The proposed vehicle, known as a Real Estate Investment Trust (UK-REIT), would be:

- a closed-ended company, resident in the UK, that is publicly listed on a Recognised Stock Exchange⁵;
- required to separate out its income between taxable and non-taxable portions, referred to as 'ring fenced' (non-taxable) and 'non-ring fenced' (fully taxable); and
- also required to distribute at least 90% of its ringfenced profits to investors and to withhold basic rate tax on these distributions.

2.13 The ring fenced part of the UK-REIT would represent at least 75% of the vehicle's activity by income and assets.

2.14 UK-REITs would be subject to an interest cover test on the ring fenced part of their business. Failure of this test will result in an additional tax charge rather than loss of eligibility for the regime.

2.15 The UK-REIT would be required to meet existing regulations on close companies⁶, and no shareholder who had beneficial entitlement to dividends would be allowed to control (either directly or indirectly) 10% or more of the UK-REIT's share capital or voting rights. Where this rule were breached, a tax penalty would apply as set out below.

2.16 Where a UK-REIT acquired a property to develop or refurbish for its own investment purposes and subsequently sold that property within three years of the completion of such works, the proceeds of that sale would not be tax-exempt if the costs of development or refurbishment exceeded 30% of the fair value of the asset at the point at which it was brought into the UK-REIT regime.

2.17 The legislation provides for groups of companies to elect to join the UK-REIT regime.

2.18 The income and asset tests, which require that 75% of the UK-REIT's income derives from property rental and that 75% of assets are used in that business, would be applied to the group as a whole.

2.19 The parent company would be required to distribute 90% of the property rental income of its UK resident subsidiaries and rents derived from UK property owned by foreign subsidiaries.

⁵ As defined in section 841 of Income and Corporation Taxes Act 1988 (ICTA).

⁶ Within the meaning of section 414 of ICTA.

2.20 All tax-exempt property income forms part of the distribution paid out by the group under deduction of withholding tax, or, where income is not tax-exempt, it is paid out as a normal dividend.

2.21 Where the UK-REIT holds property through foreign subsidiaries (which are not subject to UK taxation on overseas property), the income paid up by this subsidiary company to the UK parent company would be treated as a dividend from an overseas company, as it is now, and taxed accordingly. A foreign subsidiary holding UK property would be exempt from UK tax on the rents earned from that property.

2.22 On election, joint venture entities would have an exempt ring fence to the extent of ownership by the UK-REIT providing that a 75% subsidiary of the parent company owns at least a 40% interest in the entity.

Costs and Benefits

2.23 The Government has stated as one of its key objectives that any reform to the property investment market should be introduced at no overall cost to the Exchequer (see Budget 2004 consultation and Budget 2005 discussion papers). It is the Government's view that the proposed model published today would lead to some overall reduction in Exchequer receipts. In order to offset this, the Government set out at Budget 2004 its intention to levy a charge for companies joining the UK-REIT regime.

2.24 The Government is committed to meeting the above objective and details of the charge applying to companies joining the regime have been announced at Budget 2006. Companies wishing to join the regime will be required to pay a sum equal to 2% of the gross value of the assets, which they intend to include in the tax-exempt ring fence. This will ensure revenue neutrality for the long-term public finances. Other costs and benefits relating to the administrative implications of introducing UK-REIT legislation are considered below.

Sectors and Groups Affected

2.25 The main business sectors that would be affected by this measure are the property investment industry and the investment and fund management industry. There are potential wider economic benefits for UK businesses and individuals from more efficient management of property as a productive factor and as a financial asset.

2.26 The property sector makes a significant contribution to the UK economy. The 2005 National Accounts 'Blue Book'⁷ published by the Office for National Statistics shows that a combination of residential buildings and commercial, industrial and other buildings represented around two-thirds of non-financial assets on the national balance sheet in 2004. The value of residential buildings was £3427 billion and the value of commercial property £624 billion.

2.27 To determine what proportion of the companies likely to be directly affected by the legislation are small and medium sized enterprises (SMEs), a sample of companies from the property investment industry was examined, which included the largest listed and private property investment companies, but possibly did not include all of the smaller companies. From this sample we found that around 80% are large companies,

⁷ <http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=1143>

around 17% medium-sized companies, and the remainder small companies, according to the criteria set by the Small Business Service⁸.

Benefits

2.28 This measure would have the following potential benefits:

2.29 Small investors (retail and smaller institutions) would have greater access to property through a diversified savings portfolio, without being subject to the potential risks, large capital outlays or tax inefficiency, which they currently face when choosing to invest in property.

2.30 Information obtained from an Investment Management Association survey⁹ on the asset allocation of retail investors (as well as pension and insurance funds) found that in 2004 investment in property accounted for 2.4% of the portfolio of retail investors, compared with 4.5% for pension funds and 9.7% for insurance funds. Assuming that larger institutions have a greater proportion of their investments in property because it is more accessible to them, we might assume that the proportion for retail investors could increase to similar levels once they have access to shares in UK-REITs;

2.31 Business would be expected to benefit from an improved supply of good quality, well maintained, competitively priced accommodation, as a more efficient utilisation of financing sources allows for greater investment. Owner occupying businesses might find that the opportunity of releasing property assets to professional building managers would allow them efficiency gains from specialisation in their core business;

2.32 The UK economy would be expected to benefit through greater efficiency in the allocation of investment resources and a rebalancing of debt and equity in the financing of property companies. The privatisation of 12 listed companies, perhaps partly driven by tax regulations, caused the listed sector to decrease by as much as 25% between 1999 and 2003 – we would expect this trend towards delisting to be halted under a UK-REIT regime, with companies' behaviour being driven by economic fundamentals and not tax regulations; and

2.33 The private rented sector would be expected to benefit from improved management through the involvement of large institutions in the form of UK-REITs, and developers would be expected to bring forward more housing supply to the private rented sector with UK-REITs there to act as willing purchasers.

Costs

2.34 In order to illustrate the direct costs to a property company of electing to join the UK-REIT regime and then complying with it on an ongoing basis, some simple case studies were included in the partial Regulatory Impact Assessment published in December 2005. These are included at Annex 2.

2.35 From consultation responses received from industry and others, it has not been possible to quantify the costs in detail, but these will relate primarily to the costs of monitoring the income and assets of the company and the composition of the

⁸ <http://www.sbs.gov.uk/sbsgov/action/layer?r.s=sl&topicId=7000000237>

⁹ <http://www.investmentuk.org/news/surveys/default.asp>

company's shareholders, to ensure ongoing compliance with the requirements of the regime. The Implementation and Delivery Plan at Annex 1 contains more detail.

2.36 The costs to HM Revenue and Customs in implementing the regime fall into three main areas:

- changes to Corporation Tax Self Assessment (CTSA) forms;
- changes to the systems for the transfer of electronic data; and
- the introduction of a new certification form that UK-REITs would complete alongside their annual CTSA return.

2.37 This new form would demonstrate how UK-REITs had met the obligations of the regime. Guidance material, including internal guidance manuals, would need to be prepared and training carried out before the introduction of the regime. Apart from issuing guidance, no impact on the income tax self-assessment return for investors is anticipated. Ongoing costs for HM Revenue and Customs will arise from the need to monitor compliance with UK-REIT obligations within the self-assessment regime. These costs are not expected to be large.

2.38 It is not anticipated that there would be any significant negative impacts on the costs of goods, services or technologies or on levels of investment.

2.39 Nor is it anticipated that there would be any additional impacts on devolved regions, human rights, the environment, rural areas or crime.

Small Firms Impact Test

2.40 From responses received to the consultation, and further discussions with the authors of these responses, the Small Business Service, and other interested parties, the Government has concluded that it is unlikely that there would be an adverse effect on small and medium sized enterprises as a result of the introduction of the UK-REIT regime. As noted above, businesses in general should benefit from a more efficient property market, since property is an important factor of production.

Competition Assessment

2.41 The impact of the proposed UK-REIT regime was assessed by applying the competition filter to the property investment market. It was found that an in-depth competition assessment is not warranted.

2.42 The property investment market is the principal market that would be affected by the measure, though there might be some associated impacts on development activity. This sector is characterised by relatively high market intensity with less than a dozen firms accounting for a majority of the whole UK listed market in terms of net asset value, employees and turnover. It is anticipated that the concentration of the UK-REIT market would largely reflect this concentration. Responses received to the consultation largely supported this view.

Enforcement, Sanctions and Monitoring

2.43 A UK-REIT would be required to meet the tests for the balance of ring fenced and non-ringfenced business, on asset and income bases at the end of each accounting period. It would be subject to the penalties and provisions of the Corporation Tax Self Assessment regime and would self assess that it has met the relevant conditions to

qualify as a UK-REIT in its tax return. In the case of a Group UK-REIT, the principal company would make this declaration on behalf of the members of the group. HM Revenue and Customs would have the normal powers to enquire into the accuracy of the return. Additionally, the UK-REIT would need, without unreasonable delay, to inform HM Revenue and Customs if it had breached a condition. Failure to make this notification would result in penalties arising.

2.44 The effect of a breach of a regime condition will depend on the size of the breach, the nature of the condition and the number of times that a breach has occurred.

2.45 Breach of certain conditions will always result in the company being removed from the regime with effect from the end of the accounting period prior to the breach. The conditions falling in this category are UK tax residence, nature of share capital and debt, listing and not being an Open Ended Investment Company (OEIC) or close company.

2.46 Breaches of other conditions will not normally result in removal from the regime unless the failure is very significant or occurs on a number of occasions – a major breach.

2.47 Minor breaches of these conditions are dealt with as follows:

- Minor breaches of the distribution requirement will result in additional tax being payable to ensure no loss to the Exchequer.
- Conditions in respect of the nature and value of the properties held and the balance of business will not result in a tax penalty. However, a company may suffer removal from the regime if any one breach is very significant or if breaches occur repeatedly over a ten-year period.

2.48 Breaches of the 10% shareholding requirement will result in an additional tax charge arising unless the UK-REIT has undertaken reasonable steps to ensure that the condition is not breached. Courses of action that HM Revenue and Customs consider to be reasonable steps for this purpose will be set out in guidance in due course.

2.49 If a UK-REIT is involved in tax avoidance, HM Revenue and Customs will have the power to require that the tax, which the company sought to avoid is charged and then that an additional tax charge is assessed, which is broadly equal to the tax that the company sought to avoid. If such avoidance is entered into a second time, HM Revenue and Customs may remove the company from the regime.

Post-Implementation Review and Evaluation

2.50 Ongoing monitoring and evaluation of the impact of the UK-REIT regime will focus on the areas identified above:

- the participation by small investors in indirect investment in property;
- the degree of liquidity in the commercial property market;
- the proportion of commercial property which is owner-occupied;
- the levels of debt in the commercial property sector;
- the degree to which the introduction of the UK-REIT regime has halted the trend for UK property to be owned by unlisted or offshore vehicles;

- the degree to which removing tax distortions has aided investment choices; and
- the setting up of residential UK-REITs in the private rented sector.

2.5I Since the effects of the regime on these areas will only become apparent over a relatively extended period of time, it is unlikely that any review or evaluation will be useful until at least three years after the first companies join the regime. The costs of compliance and administration may be reviewed at an earlier date.

Annex 1: Implementation and Delivery Plan

A.1 This plan sets out the activities a company would need to undergo in order to qualify to join the UK-REIT regime, and continue to qualify on an ongoing basis. The Government requested information from industry on the likely costs of these activities, but received no response. An assessment of the costs in Standard Cost Methodology terms will be undertaken as and when further information becomes available.

Table 2.1 Company activities for qualification to join the UK-REIT regime

	Activity
Set Up	Set up computer and administrative systems to monitor the required splits in assets and activities.
Registration	Register the UK-REIT with HM Revenue and Customs providing the evidence requested and pay the conversion charge as assessed.
Complete the Annual Return	Ongoing monitoring using the systems outlined above Identification of dividend streams to ensure that the 90% distribution test is met and that the correct withholding procedures are applied Monitoring the size of investors' holdings, and compliance with the 10% holding restriction Provide details of non-ring fence profits in the normal CTSA form. Provide details of ring fence profits in new CTSA equivalent form. Provide details of consolidated income and assets for a Group UK-REIT.
Compliance Regime	Dealing with any compliance regime associated with the regime, for example in providing HMRC with any additional information requested.

Annex 2: Case studies

Case Study One: XYZ PLC

A.2 XYZ PLC is an existing property company, resident in the UK and listed on the London Stock Exchange. In order to join the UK-REIT regime, it might have to do some or all of the following, depending on the current structure of the company.

- restructure the company, and possibly any group or subsidiary structures, so as to ensure that at least 75% of its assets and income are eligible for ring-fencing;
- pay any costs arising from this restructuring;
- set up computer and administrative systems to monitor the split between ring fenced and non-ring fenced assets and income;
- establish procedures to apportion expenditure between ring fenced and non-ring fenced activities;
- put in place arrangements to monitor the origins of dividends derived from group companies (i.e. whether derived from property rental, capital disposals or other income), monitor foreign tax credits attaching to non-ring fenced income, and to calculate the average minority shareholding for the purposes of tax calculation;
- apply the grouping tests; and
- incur internal management, legal or consultancy costs associated with the above.

A.3 Once in the regime XYZ PLC would face ongoing costs to cover the following:

- ongoing monitoring using the systems outlined above;
- identification of dividend streams to ensure that the 95% distribution test is met and that the correct withholding procedures are applied; and
- monitoring the size of investors' holdings, and compliance with the 10% holding restriction.

Case Study Two: LMN Property

A.4 LMN Property is an unlisted property company, resident in the UK. The costs it might face would be broadly similar to those in Case One above, with the addition of any costs associated with listing on a Recognised Stock Exchange and managing its relationship with its shareholders.

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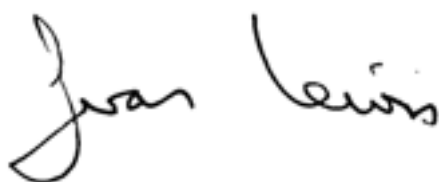
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REGULATORY IMPACT ASSESSMENT**Real Estate Investment Trusts (UK-REITs)****Statement of Ministerial Approval**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

A handwritten signature in black ink that reads "Ivan Lewis". The signature is written in a cursive style with a large initial 'I' and 'L'.

Ivan Lewis
Economic Secretary to the Treasury

Dated: 15 March 2006

3

REGULATORY IMPACT ASSESSMENT FOR REFORM OF FILM TAX INCENTIVES

PROMOTING THE SUSTAINABLE PRODUCTION OF CULTURALLY BRITISH FILMS

Introduction

3.1 This final Regulatory Impact Assessment (RIA) updates the partial RIA published on 29 July 2005.

3.2 In Budget 2005, the Government announced its intention to replace the current structure of tax relief with a new tax relief model. Introducing new relief for the production of qualifying UK films, and removing previous reliefs Section 42 of the Finance (No.2) Act 1992 and Section 48 of the Finance (No.2) Act 1997 (S42 and S48).

3.3 A consultation document was published in July 2005, alongside draft legislation and explanatory notes. A further announcement on the value of the new reliefs was made at the Pre-Budget Report on 5 December 2005.

3.4 Further information on film tax relief is available at <http://www.hmrc.gov.uk/films>.

Purpose and Intended Effect

The Policy Objectives

3.5 The core aim of the new film tax relief is to promote the sustainable production of culturally British films. Within that, the new reliefs are designed to deliver a number of related objectives:

- promoting the production of films that might not otherwise be made; in particular, ensuring higher levels of support for low budget films;
- ensuring better value for money for taxpayers and for film producers through direct provision of benefit, without leakage of support, to filmmakers themselves;
- removing the need to access the relief through intermediaries to ensure easier, direct access to reliefs;
- removing distortions caused by the current reliefs by reducing avoidance risk and stabilising investment levels;
- ensuring greater flexibility for filmmakers in an increasingly global industry;
- ensuring sustainable production by creating closer links between Exchequer support for cultural film production and maintaining a critical mass of infrastructure, creative and technical expertise;
- ensuring better coherence by providing that the tax relief is targeted on its intended objective and directly influences decisions about the location of film making activity; and

- ensuring that the structure of the tax relief fits within the industry's financing model, but also encourages a behavioural shift towards more stable and sustained levels of investment.

Background

3.6 There are currently two special tax incentives available for the production of films in the UK. The first was introduced by Section 42 of the Finance (No.2) Act 1992, and the second – available for qualifying films with total expenditure of £15 million or less – by Section 48 of the Finance (No.2) Act 1997. S42 allows eligible expenditure to be deducted over a minimum of three years. S48 allows eligible expenditure to be deducted immediately upon completion or acquisition of the film.

3.7 While S42 ('large budget tax relief') was not time limited, S48 ('low budget tax relief') was introduced as a temporary measure, and was originally due to expire in 2000. It has since been extended on three occasions by Parliament and is now due to expire on 31 March 2006. Both reliefs aim to give support to the British film industry, but in recent years they have been the target of aggressive tax avoidance activity.

3.8 In Budget 2005, the Chancellor announced that the current relief for low budget films, originally due to be replaced in July 2005, would be extended in recognition of the film industry's uncertainty about how the new relief would operate in practice. The Budget also announced a review of the current relief for large budget films, having concluded that it was no longer an effective means of delivering Government objectives for promoting a sustainable UK film industry.

3.9 The outgoing films tax regime, as well as providing relief on film production costs, also allows relief on the acquisition of a film by third parties from a producer and has been the source of significant avoidance activity. The new film tax incentives are aimed directly at film production companies to ensure that the incentives are targeted where they are most effective in encouraging film production, whilst ensuring value for money for the British taxpayer.

Rationale for Government Intervention

Removing S42 and S48 and introducing new reliefs

3.10 The existing reliefs are an inefficient means of supporting the production of culturally British films and are particularly prone to leakage – allowing much of their value to go to financial intermediaries and other third parties, rather than film producers. Under the current arrangements, producers are forced to use complex sale and leaseback financial structures to access the benefits of the relief.

3.11 S42 and S48, in addition to delivering an inefficient incentive, are also a rich source of tax-avoidance opportunities. Retaining the current reliefs would necessitate further and continuing anti-avoidance legislation, making the existing regime increasingly unstable and uncertain for film producers.

3.12 The Government has stated its desire to continue support for film production in the UK, but considers that the existing arrangements deliver poor value for money for UK taxpayers and inefficient support for film producers. The new reliefs will deliver Exchequer assistance in a more efficient vehicle that better supports the sustainable production of culturally British films by targeting relief directly at producers.

Outline of new scheme

3.13 The new reliefs will be provided directly to filmmakers themselves and will apply to films that are certified as culturally British, under a new test administered by the Department of Culture, Media and Sport (DCMS). Qualifying films must spend a

minimum of 25% of their total production expenditure in the UK. Enhanced relief is available on up to 80% of the total qualifying production expenditure (comprising pre-production, principle photography and post-production).

3.14 For qualifying films costing up to £20 million:

- An enhanced deduction of 100%; and
- A payable tax credit at a level of 25%.

3.15 For all other qualifying films:

- An enhanced deduction of 80%; and
- A payable tax credit at a level of 20%.

Consultation

Within Government

3.16 HM Treasury, HM Revenue & Customs (HMRC), DCMS and The UK Film Council have worked together closely on these proposals from the outset.

Public Consultation

3.17 HM Treasury and HMRC have been consulting with the film industry and other interested parties on the reform of film tax relief since September 2004, when consultation began on a new low-budget film tax relief to replace the S48 tax relief. Full consultation on a replacement structure for both S42 and S48 was announced in Budget 2005 and formal consultation began with the publication of a consultation document, draft legislation and explanatory notes on 29 July 2005.

3.18 Over the 12-week consultation period, HM Treasury, HMRC and DCMS held a series of formal and informal consultative meetings with the industry and other related parties. 52 written responses were received and several respondents have continued to engage in informal discussions on the detail of the new relief. The Government has welcomed the comments received during this consultative period.

Options

1. Make S48 permanent and leave S42 in place

3.19 A continuation of the current reliefs was considered and rejected by HM Treasury in a review last year. The current reliefs have succeeded in increasing investment in UK film production, but while an extension of the current reliefs would maintain support for film production, the review found overwhelming evidence to support reform of the existing reliefs.

3.20 The main findings of the analysis, supplemented by a series of discussions with the film industry, were that the existing film tax reliefs were not effective in meeting the Government's objectives for film policy. The existing reliefs provide poor value-for-money for the taxpaying public: they are inefficient and a large proportion of their value leaks to financial intermediaries. In addition, they have provided a rich source of tax avoidance opportunities, in part due to the opaque sale and leaseback structures required by film producers to access the value of the relief. Extending the current reliefs

would require significant resource within HMRC to monitor and tackle the avoidance risk effectively.

3.21 Tax avoidance activity through the existing reliefs has also created a certain amount of unwelcome market distortion. While a key objective of tax reliefs is to facilitate the operation of the market in as non-distortionary a manner as possible, the potential for tax avoidance has led to the production of poor quality products made solely for the purpose of claiming accelerated tax relief to shelter other economic activities from tax.

3.22 Finally, the application of the current reliefs to worldwide expenditure can also have a distortive effect. It can actually act as a disincentive to spend money in the UK, particularly where incentives from other jurisdictions are available. To achieve the Government's objectives, any film tax relief must reverse this situation.

2. Allow S48 to expire and leave S42 in place

3.23 This option would mean that S42 would be the only tax incentive available to any qualifying film. In view of the conclusions on option 1 (above) this would fail to meet the Government's objective to support film production.

3. Extend the grant system

3.24 There are a number of reasons why support for films is not supplied entirely through direct subsidy. The Government's strategy is to provide support through a combination of direct subsidy and support through tax reliefs.

3.25 Grant funding for film production is allocated on a film-by-film basis and requires subjective judgement to be applied. The grant funding mechanism plays an important role in encouraging specific films to be produced. Particularly, where the film production market would not otherwise support the production of a film. Grant funding is therefore most successful in promoting the production of less commercial films.

3.26 However, while direct subsidy can be useful in encouraging activity that the market would not otherwise perform, the direct involvement of Government is not always suitable. Tax relief has the advantage of directing Government support entirely within a market-based mechanism, allowing the market to make objective decisions about film production while influencing decisions at the margins.

3.27 In this way, tax relief is well suited to allowing film production companies to capture the wider spill over benefits to society that stem from the production of culturally British films. While grants can only support a small, targeted number of films, tax relief can provide support for a much wider number of films at lower administrative cost, allowing the production of culturally British films that, without tax relief, would be marginally unviable and promoting the sustainability of the British film industry

4. Remove all tax relief for film production

3.28 Film production is a global industry, with location decisions influenced, amongst other factors, by the generosity of state support. The availability of Government support is therefore an important factor in investment decisions, particularly where it can reduce the costs of producing in a high-cost environment such as the UK.

3.29 While the end of film tax relief would have the immediate benefit of removing a key source of avoidance and uncertainty in the tax system, it would also carry a significant social and cultural cost. In the absence of any enhanced tax relief, film production companies would not be able to capture any of the wider spillover benefits to society that stem from their production of culturally British films. Given this, films of significant cultural value but that might be marginally commercially unviable would not be made in the absence of tax relief.

3.30 Beyond this, the removal of all tax relief would have significant impacts on sustainability of a critical mass of film production infrastructure in the UK. This is especially so given the global nature of the film industry, with location decisions influenced, amongst other factors, by the generosity of state support. In the absence of UK tax relief, cost savings abroad from cheaper labour and from similar tax incentives may encourage UK film producers to produce films outside the UK and there would be an associated drop in inward investment.

3.31 The loss of tax incentives would therefore place in jeopardy the UK's 'critical mass' of key film production infrastructure and skills and would discourage the production of culturally British films in the UK. As a further consequence, film producers may seek to rely more heavily on alternative sources of public subsidy, including lottery funding.

5. Replace both existing reliefs with a new model targeted at producers

3.32 The chosen option is therefore to introduce a reformed system of film tax reliefs, targeting support directly to producers. The new reliefs will provide more generous relief, with the minimum of leakage to third parties. In conjunction with a new cultural test, they will incentivise the production of culturally British films, contributing towards a 'critical mass' of key infrastructure and skills and safeguarding the sustainable production of culturally British films.

Costs and Benefits

Sectors and Groups Affected

Film Makers and Film Practitioners **3.33** The new film tax reliefs will be claimed directly by the film production company, without the need for complex sale and leaseback financial structures. With no leakage to third parties, the reliefs will deliver more generous support to film production, with a lower overall cost to the Exchequer.

3.34 The new reliefs will support a wide range of activities encompassing the full range of film production, including pre-production, principle photography and post-production. They will provide an additional incentive to perform activities that, at present, are often not performed in the UK because of cost constraints. They will also be more effective in building a critical mass of film production infrastructure, supporting a wider range of creative and technical skills in the UK.

3.35 The relief makes no distinction between inward investors or indigenous producers, but the relief will be maximised when 80% of the total spend on a film is spent in the UK, incentivising the use of UK facilities and creative skills in filmmaking.

Individuals and Partnerships **3.36** The new relief will only be available to film production companies. Individuals and partnerships will no longer be able to get relief for film acquisition costs for tax purposes. Film producers are free to form a film production company to benefit from the new reliefs. It is not therefore anticipated that a restriction to film production companies will negatively impact film production.

Co-Producers **3.37** The new reliefs will apply across the board to both wholly UK-based productions and co-productions with other countries. There is no explicit distinction. At present, the arrangements permit tax relief on the worldwide spend for a co-production. In many cases, this incentivises film production abroad, and does not reconcile with the Government's objective to create a critical mass of infrastructure and skills within the UK. The structure of the new reliefs means that films of this type will naturally receive less Government support than under the previous relief. Furthermore, it is an explicit objective of the new relief to encourage a behavioural shift to bring future film production activity to the UK.

3.38 The Government does however recognise the cultural and economic benefits of co-productions and has taken steps to ensure that genuine co-production activity can continue to benefit from the new reliefs. Film producers are required to spend a minimum of 25% of the film's total budget in the UK. This threshold has been set to permit bi-lateral and multi-lateral film production to continue with tax relief – while excluding film production that only uses a minimal amount of UK skills and infrastructure. There are also additional avenues for Government support, including lottery funding.

Financiers **3.39** The new proposals are designed specifically to exclude financiers and other intermediaries from accessing incentives intended for film production. They will therefore be unable to exploit opportunities for tax avoidance using film reliefs.

Voluntary Organisations and Charities **3.40** No related impacts on these organisations have been identified.

Equality Impacts including Race and Northern Ireland

3.41 No adverse equality impacts have been identified.

3.42 As a tax-based incentive the new reliefs are available across the UK, including Northern Ireland. No specific impact in Northern Ireland is anticipated.

Human Rights Issues

3.43 None have been identified.

Benefits

3.44 The benefits of removing the S42 and S48 reliefs and replacing them with a new regime are numerous. They can be broadly summarised as:

- Better-targeted support, directly to filmmakers, with the minimum of leakage to financial intermediaries and other third parties. This will permit more generous levels of support for film production and a lower overall cost to the Exchequer.

- In conjunction with the new ‘cultural test’, administered by DCMS, the new reliefs give more effective support for the sustainable production of culturally British films.
- Increased levels of investment, from both domestic and foreign investors, fostering a sustainable market for film production in the UK with an incentive to retain the profits of filmmaking in the UK – and creating a critical mass in infrastructure and creative and technical skills.
- A reduction in films tax relief-related tax avoidance, bringing with it an associated reduction in the need for anti-avoidance legislation and greater stability in the films-relief structure.

Costs

Exchequer

3.45 The new film tax relief is estimated to cost £20 million in 2006-07 rising to around £120 million a year thereafter. Taking account of the savings from expected costs of the film tax reliefs being replaced, the total Exchequer effect is estimated to be +£30 million in 2006-07, -£20 million in 2007-08 and +£20 million in 2008-09.

Administrative Costs

3.46 Claims for the new relief and for the payable tax credit will be embedded in the computation of taxable profits or losses. Discussions with the industry confirm that film-makers maintain and organise records in a way that facilitates extraction of information (for instance that expenditure relates to services performed in the UK) needed to make the claim. This minimises the additional administrative costs to business in claiming this valuable relief.

3.47 The new reliefs will be similar in operation to enhanced reliefs and payable tax credits available for expenditure on qualifying Research & Development. This provides an administrative model, and existing processes, that will minimise additional costs for HMRC. It is envisaged that necessary modifications to forms and guidance will be handled within the normal baseline for the annual review and updating of these forms and systems.

Social Impacts and Influences

3.48 The new tax relief is available for the costs of producing culturally British films. We anticipate beneficial social impacts through the production of a higher volume of films reflecting the UK’s diverse history, cultural beliefs and shared values.

Environmental Impacts

3.49 No direct impacts have been identified.

Small Firms Impact Test

3.50 The new reliefs apply to all film production companies, regardless of size. Analysis shows that the standard model of film production is to bring packages of creative and technical skills together to work together on a particular project. Most films are therefore made through a special purpose vehicle, which is used once for a

particular film. On this basis, no specific or disproportionate impact on smaller firms is anticipated.

Competition Assessment

3.51 Analysis shows the new regime will not have any adverse impact on competition within the film industry. It is designed to apply equally to all qualifying film production companies.

3.52 The proposed relief has been formally notified to the European Commission to ensure that it meets the criteria for a State Aid and is fully compatible with the Commission's rules on competition within the European Union.

Enforcement, Sanctions and Monitoring

Enforcement

3.53 The new rules will be enforced as part of HMRC's existing processes for ensuring compliance with the tax system. Claims for the new relief will be embedded in the normal return of Corporation Tax profits or losses, and claim for payable tax credits. It is expected that the majority of claims will be by companies specially set to produce a named film in line with normal industry practice. Such returns including film related claims will be channelled to designated officers familiar with the industry and the specialist legislation. These specialist officers will form a virtual network able to exchange information and best practice and will be led by experienced officers in HMRC's Large Business Service working with the media sector.

Sanctions

3.54 The new relief enables ongoing projects to access relief on the basis that their plans for film production will be followed across a number of accounting periods. While there will be mechanisms to allow adjustment of relief and payable tax credits, including their recovery where conditions are breached, the current sanctions and penalties in the existing tax regime will apply equally to the new film tax reliefs. There are no additional sanctions for the new reliefs.

Monitoring and Evaluation

3.55 Claims for the new film tax relief will be identified in the production company's self-assessment tax return. This information will allow claims for relief and the associated costs to be monitored on a regular basis. The new film tax relief will also be evaluated over time to assess its performance against its wider objectives, and so allow a judgement to be formed on the effectiveness of the relief in light of its costs.

Implementation and Delivery Plan

3.56 Discussions with the industry indicate that conventional management information systems used by the industry will provide the necessary information to enable claims for the new relief to be made as part of the normal process of submitting the statutory Corporation Tax return. The records needed to support claims to the new relief and if appropriate to the payable tax credit will be the same as are currently required to support the computation of profits and management records supporting

the location of the services supplied required to identify expenditure on services within the UK for calculation of the enhancement.

3.57 The new relief is a State aid and, subject to the Commission's approval the new regime will apply to new films, those beginning principle photography after 1 April 2006 where the theoretical earliest date for the return would be 9 months thereafter and, in practice returns for the initial accounting period for which the new relief will be available are expected up to 12 months after that. Draft public guidance on the operation of the new legislation will be made available by October 2006, 3 months before the deadline for the earliest statutory return of film production company within the new relief.

Post-Implementation Review

3.58 In due course HMRC will undertake a review of the figures in this RIA in Standard Cost Methodology terms, and a separate compliance cost review will take place within 12 to 24 months following implementation.

Summary and Recommendation

3.59 In summary, the new film tax reliefs will be a more effective, efficient and valuable replacement for the current reliefs. They will target support directly to film producers, with less leakage to financiers and other third-parties and substantially fewer tax avoidance opportunities. They will permit a more generous and stable regime with less overall Exchequer cost.

3.60 In conjunction with the new cultural test, administered by DCMS, the new reliefs will provide a valuable incentive for the sustainable production of culturally British films, providing the necessary support to ensure a critical mass in key infrastructure and skills in film production in the UK.

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REGULATORY IMPACT ASSESSMENT

Reform of Film Tax Incentives: Promoting the Sustainable Production of Culturally British Films

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 15 March 2006

4

REGULATORY IMPACT ASSESSMENT FOR ALTERNATIVE FINANCE PRODUCTS

Introduction

4.1 This final regulatory impact assessment considers the costs and benefits of options for addressing the tax treatment of alternative methods of finance (including Shari'a compliant finance). It accompanies the announcement of legislation in Budget 2006 to amend certain rules for Income Tax, Corporation Tax, Capital Gains Tax and Stamp Duty Land Tax ("SDLT").

Purpose and Intended Effect

4.2 Alternative methods of finance, structured in a way that does not involve interest, were not conceived of when most tax law was drafted. As a result the tax treatment of some alternative finance products is inconsistent or uncertain when compared with conventional finance products.

4.3 The objectives of the legislation are to ensure that the tax treatment of alternative methods of finance is made certain and is, as far as possible, neither more nor less advantageous than that of equivalent financial products. This will give those people and entities wishing to utilise alternative finance products the ability to do so without being disadvantaged because of tax.

4.4 Government has been tackling the taxation of alternative finance products since 2003. There is currently legislation enabling the provision of alternative methods for an individual to finance a residential property purchase, bank deposits and personal loans.

Background

4.5 The demand for alternative finance products comes mainly from Muslims, although they may be used by any consumer. Islamic (or Shari'a) law prohibits transactions that involve interest, gambling, speculation or unethical investment.

4.6 The most pronounced difference between Islamic financing and existing equivalent products is the prohibition on interest. For customers wishing to adhere to Shari'a law, this rules out financial products that result in either payment or receipt of interest, such as conventional deposit accounts and loans. However, Shari'a law does not prohibit the making of a return on capital if the provider of the capital is willing to share in the risks of a productive enterprise. Thus profit and loss sharing arrangements are considered acceptable, provided there is shared risk.

4.7 Islamic financial transactions are structured using contracts, or combinations of contracts that satisfy the requirements of Shari'a law. Some of the most common are:

- Mudaraba financing, a partnership structure, consisting of one or more partners that contribute capital and a managing partner who contributes knowledge and expertise. The managing partner receives a fee for services provided.
- Murabaha, sometimes referred to as mark-up or cost plus financing. The financial institution purchases the goods for the customer, and re-sells them to the customer on a deferred basis, adding an agreed profit margin.

- Musharaka financing, a partnership agreement. A common form is diminishing musharaka where the partners jointly acquire an asset. The financier's share of the asset decreases through periodic payment containing elements of capital repayment and rent from the other partner, who eventually becomes the sole owner.
- Ijara, the Islamic equivalent of a conventional lease. There are several variations on this structure, one important form being ijara wa'iqatna. Ijara wa'iqatna is similar to a hire purchase agreement; the financial institution buys goods, rents them to the customer and transfers the goods to the customer in exchange for a defined terminal payment.
- Wakala, a form of agency agreement. The financial institution promises a return to the investor. The financial institution keeps any return over and above that which has been promised to the investor as their agency fee.

4.8 Financial institutions in the UK are now offering Shari'a compliant alternative finance products that are economically equivalent to conventional banking products but do not involve interest or speculative returns.

4.9 In 2003, reforms to modernise SDLT included two reliefs for Alternative Property Finance:

- The first concerned a series of chargeable land transactions that are not necessary under conventional mortgage structures, and the reform relieved those transactions from SDLT.
- The second removed the possible double imposition of SDLT on a house purchased using two Shari'a compliant financial products.

4.10 Further reforms in 2005 concerned:

- savings products (including mudaraba);
- asset finance (murabaha products);
- SDLT (lease based mortgages); and
- Child Trust Funds.

4.11 A Regulatory Impact Assessment for the 2005 changes was published in March 2005 (<http://www.hmrc.gov.uk/ria/sharia.pdf>)

Rationale for Government Intervention

4.12 The tax treatment of Shari'a compliant financial products is in some areas uncertain and in others produces anomalous results. These anomalies can put providers of Shari'a compliant products at a commercial disadvantage. Customers may also suffer a disadvantage if financial institutions have to charge proportionately more for Shari'a compliant products.

4.13 A number of issues have emerged from further consultation with representatives from the community, professional advisors and financial institutions since the changes made in Finance Act 2005. Taking these forward it is proposed to make the following changes in Finance Bill 2006.

- Enable the use of diminishing musharaka based products by business for asset and real property finance.
- Make certain the tax treatment of wakala transactions, there is currently uncertainty over beneficial ownership.
- Extend the current reliefs from SDLT to all entities, including companies, clubs and LLPs.
- Ensure that alternative finance loans at a non-commercial rate between employer and employee are treated as benefits in kind.

Consultation

Within Government

4.14 The risks to be addressed are issues of taxation; consultation has therefore taken place within HM Treasury and HMRC as the two departments involved with tax policy.

Externally

4.15 HM Treasury and HMRC have continued the process of consulting informally with consumers and providers of alternative finance products. A technical working party involving banking, legal and accounting professionals has been formed to look at the direct tax treatment of alternative finance returns. This group has been informally consulted regularly throughout the last year, the last meeting being on 7 February 2006.

Options

1. Do Nothing

4.16 This option will leave the risks and uncertainties set out above in place, disadvantaging those who wish to utilise alternative finance. Islamic banking is a worldwide growth area – tax barriers will restrict the competitiveness of UK institutions (or UK branches of overseas banks) that wish to offer Shari'a compliant products.

2. Legal Opinion

4.17 Seeking a legal opinion of the tax treatment of each product seen and publishing it with guidance. This would remove any uncertainty over how much tax the parties were liable for and enable commercial decisions to be made about whether or not to proceed. However, this is only a temporary solution as products will need to be considered on an ad hoc basis and does not address the issues arising when an anomalous tax treatment is found.

4.18 As legal opinion can only be sought on existing products, this solution cannot address the need to provide a clear framework for developing new products for the UK market.

3. Legislation

4.19 After internal analysis and consultation, the preferred way forward is to recommend a legislative solution. However, the precise form of the legislation requires careful consideration to fit with existing tax law for financial products and the UK's

responsibilities under its network of taxation treaties. In consultation it emerged that it would not be possible to address all tax issues affecting the development of Shari'a compliant products with a single piece of legislation. We shall therefore be continuing the consultation process through to Budget 2007.

Costs and Benefits

Sectors and Groups Affected

4.20 These issues affect three main groups:

- Muslim consumers;
- Small businesses; and
- Financial institutions.

4.21 Muslim consumers are the main market for alternative finance products due to the prohibition on interest contained within Shari'a law. The current uncertainty over tax treatment of some alternative finance products, combined with the continuing double SDLT for persons who are not individuals has limited the growth of the regulated market.

4.22 Initially, Shari'a compliant products were geared primarily towards individuals. Financial institutions are now extending Shari'a products to businesses. Muslim businesses are expected to be major beneficiaries of this legislation as it will enable them to make their capital structure Shari'a compliant.

4.23 Since initial legislation in 2003 opened up the market for alternative finance mortgages a wide number of financial intuitions have participated in the market. These institutions have expressed an interest in developing a full range of alternative finance products for the retail, commercial and private clients. Over time a significant proportion of the customer base for providers of alternative financial products is likely to be the proprietors of Muslim run small businesses who wish to comply with the provisions of Shari'a law. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

4.24 There is likely to be some shift from conventional finance products to alternative finance products as people adopt the method of finance most suited to their needs. Financial institutions who offer only conventional products may therefore see a reduction in trade, but within the context of fair and open competition.

Benefits

1. Do Nothing

4.25 There are no appreciable benefits of this option. This option will do nothing to address the underlying tax problems set out above and will therefore be of no benefit to customers and businesses who require alternative financial products nor to the financial institutions who offer them.

2. Legal Opinion

4.26 Providing legal opinions on individual products would offer limited benefits. It would offer some certainty over the tax treatment, but it is not a judgment so has no

legal force. In addition alternative finance products with the same economic effect often have quite different legal structures and wordings. It is possible that products structured in the same way could therefore have quite different tax treatments.

3. Legislation

4.27 The clarification of tax rules has the potential to further encourage development of Shari'a compliant financial products within the UK. The emergence of a thriving and competitive market in Islamic finance products could substantially benefit London as a global financial centre, generating further investment, jobs and tax revenues in the UK economy.

4.28 The primary policy objective is to remove existing inequalities that derive from the inapplicability of existing legislation to the taxation of alternative financial products, and to offer genuine choice to consumers wishing to take up these products. The Exchequer effect in the short term is expected to be minimal, but potentially positive in the long-term if more institutions offer such products, if the existing product range is expanded, and if the customer base continues to expand.

4.29 Continued difficulties with the development of Shari'a compliant products has the potential to cause difficulty and frustration for the UK Muslim community. There are clear social and equality benefits in the wide availability of well-defined, well-regulated financial products in all sections of the community.

4.30 It is reasonable to expect that the development of a regulated Islamic financial sector in the UK would bring into the regulated environment financial transactions that may currently be taking place without any significant regulation or consumer protection.

Costs

1. Do Nothing

4.31 Failure to act would not remove the uncertainties that inhibit the provision of Shari'a compliant financial products. It is unlikely that these products will be widely offered if the existing tax uncertainties are not addressed, with the result that any possible contribution towards financial inclusion and savings and asset objectives would be very limited. Informal provision of finance may continue on a similar scale as before.

4.32 There would be continued economic cost from this option. This could prevent financial institutions offering Shari'a compliant products or, for the major banks, locating their Islamic banking operations outside of the UK. Without the removal of existing uncertainties over the tax treatment of Shari'a compliant financial products, it is unlikely that there would be an appetite to offer them amongst high street financial institutions.

2. Legal Opinion

4.33 Legal opinions might allow institutions offering Shari'a compliant financial products to operate with certainty in the short-term with regard to specified products but would not remove uncertainty in the longer term as products will need to be considered on an ad hoc basis. This option also cannot address the issues arising when an anomalous tax treatment is found.

4.34 This option would demonstrate the Government's serious consideration of the issues, but as legal opinion can only be sought on existing products, this solution cannot address the need to provide a clear framework for developing new products for the UK market.

3. Legislation

4.35 The social costs of legislating to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products are minimal. This is however an evolving market. We already aware that products are being developed, that may well need further legislation. The main risk is that, by raising customer expectations, HMT and HMRC will face continuing demands for further legislation as financial institutions develop more sophisticated Shari'a-compliant products that are not covered by existing provisions.

4.36 It is unlikely that legislation will have a significant Exchequer impact. For example, with regard to the changes to SDLT, Muslim businesses have been utilising conventional finance products and paying SDLT in the usual manner. Offering Shari'a compliant mortgages, which do not give rise to a different level of SDLT will not result in any significant change in revenue.

4.37 Legislation will not be tied to the Qu'ran or the Islamic faith, but rather uses intrinsic features of the underlying contracts under UK law to define transactions to which the rules will apply. As always, the possibility of abuse has to be considered. The legislation will therefore contain safeguards to prevent it being used for avoidance.

4.38 It is not expected that there will be a compliance burden on business. There may be a cost during the transition period as advisors and tax payers adjust to the new regime.

4.39 There is some operational impact on HMRC, who will have to ensure that systems for monitoring, reporting and auditing the deduction of tax at source are able to cope with these financial products. Amended guidance and minor changes to forms will also be needed. However, it is not anticipated that the impact and cost will be substantial.

Small Firms Impact Test

4.40 Initially, most of the alternative finance products developed were geared towards individuals. However, banks are interested in extending their Shari'a compliant business products to businesses. Over time a significant proportion of the customer base for providers of alternative finance products is likely to be Muslim proprietors of small businesses who wish to comply with the provisions of Shari'a law. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

4.41 These measures will enable small businesses to choose whether they would like to finance their investments via alternative finance products.

Competition Assessment

4.42 A competition assessment has been undertaken and the competition filter indicated that legislation to address current uncertainty and inequality in the tax

treatment of alternative finance products should not have any significant adverse effects on the competitive processes in the financial services market.

4.43 The main market affected will be the banking sector – both those institutions offering solely Shari'a compliant financial products and high street banks with an interest in offering such products alongside, albeit ring-fenced from, conventional banking products. A number of other providers offer or are planning to offer alternative property finance products. There are also private membership organisations, which offer interest-free loans (financed by membership fees) and housing finance.

4.44 In terms of competition, the do nothing option would have had no obvious positive consequences. Given the uncertainties and commercial disadvantages that would remain for providers of Shari'a compliant financial products, this option could have negative competitive consequences by restricting the profitability of offering such products, perhaps enabling only those banks willing to fund Shari'a compliant operations from other areas to compete in the marketplace.

4.45 The legal opinion option would have some competition enhancing effects by allowing providers of Shari'a compliant products to offer them with certainty of tax treatment. Given that long-term uncertainty would not be removed, it is unlikely that there would be much interest amongst other potential providers to offer these products. The effect of this option might therefore have been to restrict competition.

4.46 The legislation option could have significant positive consequences for competition. If legislation to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products is successfully introduced, it is likely that there will be considerable interest amongst other financial institutions, both mainstream and those offering solely Shari'a compliant products.

4.47 Customers (not necessarily Muslims alone) will be offered a greater degree of choice since they should not have to pay disproportionately more for Shari'a compliant than for conventional banking products. The overall effect should therefore be to encourage an expansion of both the range of financial products available and the number of institutions willing to offer them.

4.48 Islamic financial arrangements are now widely used in many parts of the world to finance major developments, such as airport construction, and in merger and takeover activity. Removal of tax obstacles will enable UK institutions to compete more effectively in this global market.

Enforcement, Sanctions and Monitoring

4.49 These are positive measures for affected parties, which allow consistent tax treatment. Avoidance disclosures will be monitored to identify, and where necessary act on, any attempt to use alternative finance arrangements for avoidance purposes.

4.50 The success, or otherwise, will be monitored on an ongoing basis through discussions with financial institutions and their advisors at the existing technical group meetings; any issues which arise being addressed in a proportionate manner.

Implementation and Delivery Plan

4.51 The policy will be implemented by legislation to be included in the Finance Bill 2006 and by guidance to be published by HM Revenue and Customs.

4.52 There will be a small administrative burden placed on businesses wishing to utilise the new legislation, as they will need to adjust to and understand the new regime. This will be more than balanced out by the benefits that the legislation brings through enabling business to choose the method of finance most suited to their needs.

Post-implementation Review

4.53 There are plans to conduct a survey of financial institutions and alternative finance consumer groups (e.g. Muslim Council of Britain) at an appropriate juncture to check the awareness of alternative finance products in the market and whether there are any further taxation issues which hinder the adoption of alternative finance products.

4.54 Ongoing informal review, through the existing technical group meetings, of the legislation allowing early consideration of any problems will continue.

Summary and Recommendation

Table 4.1 Summary Costs and Benefits

Option	Total benefit per annum: Economic, Environmental, and Social	Total cost per annum: Economic, Environmental, Social, Policy and Administrative
1	None	Parts of society excluded from regulated financing methods. Unfairly restricts the business of Shari'a compliant financial services.
2	A Legal opinions will allow institutions to offer products with certainty over how HM Revenue and Customs will treat them for tax It will allow wider access to finance from the regulated sector.	This option will carry a small administrative burden to HM Revenue and Customs. There is a risk that a court may disagree with any legal opinion. There are likely to be future costs of finding a long term solution
3	Enables a level playing field for tax purposes. Promotes financial inclusion. Promotes competition in the financial sector. Provides a framework and precedent for future work in this area.	Small administrative burden to HM Revenue and Customs. Legislation will need to be updated to reflect further products/innovations

4.55 The market for alternative finance products has the potential to be very large, but current providers of alternative finance products are rendered uncompetitive with other financial institutions due to the tax treatment of alternative finance structures.

4.56 The market has welcomed the legislation already enacted to remove unequal tax treatment from certain alternative finance products. Informal consultation has highlighted further areas containing unequal treatment. A long term solution is required to enable the UK to maintain its position as a world leading centre of financial excellence.

4.57 Legislation is therefore recommended to provide a long-term, stable, solution to the unequal treatment presently received by alternative finance structures identified.

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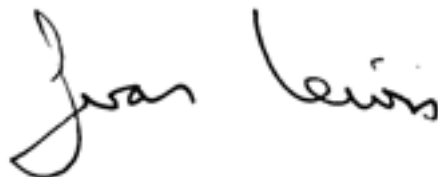
REGULATORY IMPACT ASSESSMENT

Alternative Finance Products

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Ivan Lewis
Economic Secretary to the Treasury

Dated: 16 March 2006

REGULATORY IMPACT ASSESSMENT FOR CHANGES TO THE NORTH SEA TAX REGIME

Introduction

5.1 This Full regulatory impact assessment assesses the package of changes to the North Sea Fiscal regime announced in the 2005 Pre-Budget Report.

Purpose and Intended Effect

The Policy Objective

5.2 The Government is committed to maintaining an active UK oil and gas industry and to promoting the future development of the nation's gas and oil reserves. The North Sea oil tax regime must strike the right balance between oil producers and consumers, by promoting investment and ensuring fairness to taxpayers.

5.3 The objective of the changes to the North Sea tax regime announced in the 2005 Pre-Budget Report is to maintain this balance in view of the recent significant increases in oil prices and the upwards shift in expectations of the medium term outlook for future oil prices.

Background

5.4 The North Sea fiscal regime has three tiers:

- Ring fence corporation tax (RFCT), which is similar to the normal corporation tax regime but with 100 per cent capital allowances on most capital expenditure, and an enhanced exploration supplement (EES). The EES provides an annual uplift of 6 per cent in the value of unused capital allowances due to qualifying exploration and appraisal (E&A) expenditure that are carried forward each year for a maximum of 6 years. In addition, the regime is "ring-fenced" which prevents taxable profits from oil and gas extraction in the UK and UKCS from being reduced by losses from other activities;
- A 10 per cent supplementary charge (SC) levied on oil and gas companies' profits as computed for the ring fence corporation tax above, but without allowing a deduction for financing costs; and
- Petroleum revenue tax (PRT), which is special field-based tax currently levied at 50 per cent. PRT does not apply to fields given development consent on or after 16 March 1993. PRT is deductible against RFCT and SC.

5.5 The 10 per cent SC and 100 per cent capital allowances were introduced at Budget 2002. These changes were followed by the abolition of Royalty on North Sea oil and gas production from 31 December 2002.

5.6 All three components of the fiscal regime, RFCT, SC, and PRT, act effectively as cash flow taxes: all income is recognised as it is earned, virtually all expenditure is relieved as it is incurred, and the difference between income and expenditure is subject to North Sea taxes (as appropriate). Cash flow taxes target economic rents (or supernormal profits) and are generally accepted as one of the most efficient forms of

taxation for natural resources such as oil and gas, with only a limited impact on investment rates of return and associated investment decisions.

Rationale for Government Intervention

5.7 Oil prices have been rising since late 2001, and have increased particularly sharply since the beginning of 2004. At its peak in August 2005, the price of Brent, the European standard, reached over \$65 a barrel. Since Budget 2005, robust oil demand, low levels of spare capacity, and supply disruptions have meant oil prices have significantly exceeded market expectations. As a result of these developments, market forecasters have increased their expectation of the medium-term outlook. Prices are expected to moderate from current high levels, but to remain at a higher level than the average over the last 20 years.

5.8 Increased oil prices feed directly into North Sea company profits because oil companies are price takers, and as a result of the recent sustained rises in oil prices, North Sea companies are experiencing significant increases in the economic rents they derive from the exploitation of UK oil reserves. With the shift upwards in the outlook for oil prices, the increase in economic rents can be expected to continue for a number of years.

5.9 There is a similar story in the UK gas market. Due to the UK link with European gas supply networks, UK gas prices have become increasingly tied to oil prices over the last five years. This is due to the extensive use of long-term gas supply contracts in European markets that are indexed to the price of oil. Gas producers have been able to earn additional economic rent from high gas prices fed in part by the rising oil price. Natural depletion of UKCS gas reserves will reinforce the tendency for gas prices to follow the trend of oil prices and global gas prices as the world liquified natural gas (LNG) market develops.

5.10 The growth in economic rents in the oil and gas sectors means there is a strong case for increasing supplementary charge to maintain the right balance between oil producers and consumers by promoting investment and ensuring fairness for taxpayers.

Options

5.11 Four options have been identified for meeting the objectives set out above:

Option 1

5.12 Do nothing.

Option 2

5.13 A 10 per cent increase in SC, to take effect from 1 January 2006.

Option 3

5.14 Option 2, plus the introduction of provisions that allow companies to defer the 100 per cent capital allowances on investment made in 2005 until 2006. This would ensure that the sunk costs of recent investment would receive relief at the same tax rate to be imposed on future income from that investment; and

Option 4

5.15 Option 3, but with the introduction of a new Ring Fenced Expenditure Supplement (RFES). The new RFES will replace the existing EES and will provide an annual uplift of 6 per cent for a maximum of 6 years in the value of all North Sea expenditure that cannot be relieved against other North Sea profits. EES currently applies only to qualifying E&A expenditure.

Sectors and Groups Affected

5.16 The options set out above will affect the 120 or so entities undertaking oil or gas exploration and production activities in the UK or on the UK continental shelf. The replacement of the EES with the RFES will primarily affect the small sub set of those companies that are not yet trading, or that do not have a tax liability sufficient to relieve all expenditure. These are likely to be new entrant companies or others who invest heavily in the North Sea and are an important sector for the continued vitality of oil and gas production in the UK.

Benefits

Exchequer

5.17 The table below shows the exchequer benefits from each of the options described above.

Table 5.1 Exchequer Effects (£bn)

	2006 / 07	2007 / 08	2008 / 09
Option 1	0	0	0
Option 2	2.2	2.2	2.3
Option 3	2.0	2.2	2.3
Option 4	2.0	2.2	2.3

5.18 With the exception of option 1, all of the options would produce an exchequer yield and therefore help ensure that the Exchequer receives an appropriate share of the benefits accruing to oil companies from the production of North Sea oil and gas. The exchequer impacts of the RFES build up over time, and are forecast to cost the Exchequer around £25 million in 2011-12.

5.19 The introduction of the RFES in option 4 would also help level the playing field between established companies that are able to offset investment costs against profits in year, and new entrants that can only relieve the tax losses associated with investment expenditure by carrying those losses forward and offsetting them against future profits. Option 4 may therefore improve competitiveness in the sector, although the economic benefits are only expected to be marginal.

Administrative and Compliance

5.20 The replacement of the EES with the RFES in option 4 should result in some compliance cost savings for oil companies and HM Revenue & Customs as they will no longer have to identify the proportion of tax losses that are associated with E&A activity. Instead, all tax losses will now qualify for the supplement.

Costs

Economic and Investment

5.21 Because the tax base for the North Sea fiscal regime is closely aligned with economic rents, an increase in the SC tax rate to 20 per cent carries only a low risk of substantial investment loss from planned development projects. On the basis of available industry data, but adjusted for improved project viability because of current high oil prices, the increase in the supplementary charge might be expected to have some impact on a very small number of marginal investments.

5.22 However, the potential impacts on investment by companies that currently have to carry forward losses will be partly offset by the introduction of the RFES in option 4. With the exception of the “do nothing” option, option 4 therefore has the least impact on investment.

5.23 The increase in the supplementary charge is unlikely to have a significant effect on the attractiveness of the UK continental shelf for global investment. Analysis by independent industry consultants¹ indicates that the NS tax regime is currently one of the most favourable in the world in terms of Government tax take as a proportion of total Net Present Value (NPV) of NS developments. A 10 percentage point increase in the SC will increase the Government’s share, but does not substantially alter the position of the regime as being significantly more favourable for investment than most of the rest of the world’s oil provinces.

5.24 The increase in SC to 20 per cent is expected to have only a limited impact on the UK’s comparative attractiveness, measured in terms of the expected monetary value (EMV) of exploration, against other global oil regions for exploration activity¹.

Administrative / Compliance

5.25 Changes are required to HM Revenue & Customs IT systems and the corporation tax self assessment (CTSA) return. The cost of these changes is estimated at around £300,000 in system changes. Most other changes to forms etc will be undertaken as part of the normal Budget change process so no additional charges will accrue.

Small Firms Impact Test

5.26 The options described above apply equally to large and small companies, and as a result there are no specific small firm issues.

¹ Wood Mackenzie Global Oil and Gas Risks and Rewards report (2004).

Competition Assessment

5.27 The proposed changes pass the standard competition filter test for both gas and oil markets. Oil companies are price-takers, facing a globally-determined market price for their output, and so will absorb all costs. They will be unable to pass any costs on to consumers, and the impact will be distributed proportionately across producers with no adverse effects on competition.

5.28 There is no truly global market for gas, but UK gas market liquidity is considered to be high and rising due to the existence of effective gas trading. There are therefore no expected adverse effects on competition as a result of the proposed changes.

5.29 In light of the above a detailed competition assessment is not included here.

Consultation

5.30 Although consultation was not considered appropriate on the options, the Government announced in the PBR that it intended to open discussions with industry about tackling wider structural issues that affect the stability of the North Sea fiscal regime and this process has now begun. In the partial RIA published alongside the PBR the Government also requested businesses' views on the compliance cost implications of the options identified above. No responses were received from this request.

Enforcement, Sanctions and Monitoring

5.31 The normal interest and penalty provisions within the framework of the current regulations will apply to late payments. HM Revenue and Customs expects that in estimating their payments, companies will follow normal commercial practice and apply corporate governance and appropriate standards. Guidance on the HM Revenue and Custom's approach to compliance is published on the Departmental Internet site.

5.32 The corporation tax payments of oil companies are kept under constant review due to their impact on the overall tax take of the UK.

Implementation and Delivery

5.33 The Government's preferred option (option iv) was announced in Pre-Budget report 2005 and was brought into effect on the 1st of January 2006. The measures it introduces will not create any new, or increase any current, compliance burdens on companies. Therefore a detailed Implementation and Delivery plan has not been prepared.

Post Implementation Review

5.34 The Government will internally assess the economic and tax impact of these changes as information is received on the first year of the change and on an ongoing basis thereafter. As announced in PBR 2005 the Government is also conducting an open discussion with business on the North Sea fiscal regime, alongside the existing engagements with business on other North Sea issues. (Through for example the PILOT group) Government will use these forums to further discuss the effect and efficiency of these measures. In due course HMRC will also undertake a review of the compliance cost savings in this RIA in Standard Cost Methodology terms.

Summary and Recommendation

5.35 Oil prices have increased sharply since the beginning of 2004. Since Budget 2005, oil prices have significantly exceeded market expectations, and market forecasters have increased their medium term expectations accordingly. Prices are expected to moderate from current high levels, but to remain at a higher level than the average over the last 20 years.

5.36 Increased oil prices feed directly into North Sea company profits because oil companies are price takers and, as a result of the recent sustained rise in oil prices, North Sea companies are experiencing significant increases in the economic rents they derive from the exploitation of UK oil and gas reserves. This increase in economic rents can be expected to continue for a number of years, and there is therefore a strong case for increasing supplementary charge to strike the right balance between oil producers and consumers by promoting investment and ensuring fairness for taxpayers.

5.37 Option 1 would do nothing to help meet this objective. Option 2 would increase the Government share to an appropriate level, but may have a particularly adverse effect on the post-tax returns of investments made recently. Option 3 addresses this concern by allowing companies to defer allowances on investment expenditure incurred in 2005 to 2006 where they will be relieved at the new higher rate. Option 4 goes one stage further and attempts to mitigate some of the effects on investment by new entrants by replacing the existing EES with a new RFES that provides an annual uplift of 6 per cent in the value of all unrelievable expenditure rather than just the qualifying E&A expenditure that the existing EES applies to. As a result, the Government announced at PBR 2005 that it intends to take forward Option (iv).

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REGULATORY IMPACT ASSESSMENT
Changes to the North Sea Tax Regime
Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 14 March 2006

6

REGULATORY IMPACT ASSESSMENT FOR CORPORATION TAX: EXTENSION OF GROUP RELIEF

Purpose and Intended Effect of the Measure

The Policy Objectives

6.1 This regulatory impact assessment considers the effect of changes to the group relief legislation for companies. These changes are being made in order to clarify the UK legislation following the decision of the European Court of Justice (“ECJ”) in Marks and Spencer plc v David Halsey (C-446/03).

6.2 The proposed changes will, in some limited circumstances, allow a UK company to claim tax relief for otherwise unrelievable losses incurred in the European Economic Area (‘EEA’). The changes will be tightly targeted to ensure relief is only given in these circumstances and will not, for example, allow groups to engineer their circumstances to obtain a tax advantage.

6.3 This measure will make clear for companies the UK’s interpretation of the decision of the ECJ.

Background

6.4 The group loss relief rules are designed to give businesses the ability, as far as possible, to structure their activities in the way that best suits their commercial drivers and to recognise the fact that a group of companies is an economic unit.

6.5 On 13 December 2005 the ECJ handed down its decision in the Marks & Spencer case. This case concerned the UK’s tax loss relief rules for groups of companies and whether the UK’s rules, in precluding relief for the losses of subsidiary companies established in other Member States of the European Union, constitute a restriction on freedom of establishment under articles 43 and 48 of the EC Treaty.

6.6 The ECJ ruled that these restrictions in the UK’s group relief legislation were, in principle, compatible with Community law, but went too far in denying loss relief to a parent company for the losses of a subsidiary where those losses are unrelievable in its Member State of residence. The changes to group relief proposed by the Government will amend the law to allow relief for unrelievable losses in the circumstances described by the ECJ.

Why these changes are needed

6.7 Following the ECJ’s judgment in Marks & Spencer, the existing UK legislation must be interpreted in accordance with that judgment. The Government is therefore making those changes it considers necessary in order that the UK legislation reflects Community law as clarified by the ECJ’s decision.

Consultation

6.8 HM Treasury (HMT) has worked closely with HM Revenue and Customs (HMRC) in order to ensure that the necessary changes can be made and effectively put into practice.

6.9 In the short interval between the judgment and Budget 2006, there has not been time to consult formally with business on the operation of the new rules. Moreover, any consultation would necessarily (a) have been limited in its scope, given the narrow terms of the ECJ's decision and (b) have delayed the achievement of greater certainty following that decision. Nevertheless, HMT and HMRC are interested in hearing comments from business on how best the limited extension of relief can be operated with minimal cost for the small number of claimants that may be affected.

Options

6.10 The Government considered four options in response to the Marks & Spencer decision.

1. Do Nothing

6.11 The effect of the ECJ's judgment in Marks & Spencer is that UK legislation has to be interpreted in the light of that decision clarifying Community law. This does not necessarily require a change to UK tax legislation, particularly as the circumstances where relief is given in the UK will be exceptional.

6.12 However, this approach would be very difficult to apply in practice as neither business nor tax administrators would have a clear idea of what the rules were, or the extent to which the principles of the judgment would be applied to circumstances wider than the narrow scope of the judgment.

6.13 As a result this could significantly increase compliance costs for business and administrative costs for HMRC. Also, some rules, particularly tax avoidance rules, require explicit legislation. By not legislating, the Government could risk substantial Exchequer losses through tax avoidance.

2. Legislate in 2007

6.14 This option would have allowed more time to engage with business regarding the operation of the changes needed to UK tax law to reflect the ECJ's decision in that law. However, it would also have meant continuing to work without clear legislation for another year raising compliance costs for both business and Government. It would also risk substantial Exchequer losses through tax avoidance in this period.

3. Legislate in 2006

6.15 This is the option chosen by the Government. It gives clarity for business and tax administrators through explicit rules and enables the Government to protect the Exchequer from undue loss through tax avoidance. Business can comment on the practical operation of the rules from a clear understanding of how the Government is interpreting the decision and what those rules are.

4. Abolish Group Relief

6.16 In supporting the Government's case before the ECJ some other Member States pointed out that an adverse decision could have damaged business in the European Union by making group relief, and equivalent systems in other countries, too costly to sustain. In its judgment, the ECJ clearly understood the weight of this argument, and also noted the inappropriateness of a loss being relieved in more than one country. And

it decided that relief for losses of companies outside the UK tax net need only be given in very restricted circumstances.

6.17 Since the terms of the judgment mean group relief should only be extended in very narrow circumstances, the cost to the Exchequer of that extension will be relatively small. This cost is estimated at £50m a year. The Government considers that this cost is sustainable and therefore did not need to consider the option of abolition further.

Sectors and Groups Affected

6.18 This measure will in general affect larger businesses that organise their activities in groups of companies operating in more than one country.

Other Impacts

6.19 All options have been assessed in terms of equality, sustainability, the environment, and directly attributable social costs or benefits and there are considered to be no significant impacts.

Benefits

6.20 The principle benefit to business from the extension of loss relief is to reduce the risks for UK companies carrying out business in other parts of the EEA by providing tax relief for certain losses where there is no possibility of relief elsewhere.

6.21 By choosing the option of bespoke legislation now the Government will give business certainty. In turn this should reduce the cost to business of tax advice on how the group loss rules will be applied.

Costs

Exchequer Cost

6.22 The predicted Exchequer cost of these changes is an annual cost of £50 million.

Costs to business - Compliance

6.23 The extension of the group relief rules is a benefit to business, but there will inevitably be some new costs, mainly in tax, legal and accountancy advice, for those companies that are able to claim relief under this measure. However the claims procedure has been kept as similar as possible to the existing procedure so as to reduce additional costs.

6.24 Where changes have been necessary is in relation to enquiries. These changes are needed because the unrelievable losses which are a necessary requirement before relief can be claimed in the UK are foreign losses which are not part of, or quantified under, the UK tax system. Further, the company that incurs these losses is also not subject to the UK's tax rules.

6.25 To overcome these problems, it is the UK based claimant companies that will potentially have to prove that any loss is unrelievable and that it has been correctly computed. An enquiry will therefore potentially involve a claimant company providing information about the surrendering company and any intermediary company where the loss has been declared wholly or partially unrelievable.

6.26 This is an essential part of the compliance regime to ensure that the relief is properly targeted and not abused. The Government is seeking to reduce uncertainty and any related costs through legislation and detailed guidance.

Public Sector Costs and Benefits

6.27 There will be minor additional costs for HMRC as a result of this measure in relation to a change to the company tax return and associated online services. Enquiries will be opened using HMRC's standard risk-based approach.

Small Business Impacts

6.28 Although group relief is open to all business, the international scope of the changes suggests that the measure is unlikely to have much impact on small businesses.

Unintended Consequences

6.29 There are not expected to be any unintended consequences arising from this tax legislation. The Government will include provisions to ensure that companies cannot contrive their circumstances so as to obtain relief in the UK. The Government announced its intention to introduce these provisions on 20 February 2006. Those provisions will be effective from that date.

Competition Assessment

6.30 The change to the group relief rules will affect all markets equally because the rules are not restricted to any particular business sector. These tax provisions will impose additional compliance costs for those UK resident companies making a claim. Despite this, overall it is to be expected that such companies would gain since they are unlikely to claim unless these additional costs are outweighed by the reduction in corporation tax.

6.31 It is anticipated that the legislation will not affect competition materially. It is possible, however, that the legislation will have some effect on the market structure relating to cross-border investment. This is because the new tax legislation will reduce the effective tax rate slightly and hence the difference between pre- and post-tax profits.

6.32 Firstly, there may be an increase in cross-border investment into the EEA since the new tax relief could affect investment decisions at the margin. A second effect may be that some companies choose to establish European subsidiaries rather than trading through branches of UK companies. However, these effects will be limited because relief for foreign losses will only be available in very restricted circumstances – the expected cost is just £50mn a year which compares to UK foreign direct investment into the EEA of £350bn (Office of National Statistics – 2004).

6.33 The tax relief will not restrict the ability of companies to choose the price, quality, range or location of their products. However, the decision regarding the location of production may be affected since the new legislation will make outward foreign direct investment in the EEA more attractive than investment in non-EEA countries. Given that taxation is only one of a number of factors in influencing decisions on where to establish a new business, and the very restricted circumstances where relief for foreign losses will be available, this effect is also likely to be minimal.

Securing Compliance

6.34 This measure introduces a novel problem in that it enables a UK corporate taxpayer to claim relief for tax losses incurred by a company that is not subject to UK taxation or tax rules. In order to prevent unnecessary complexity and difficulty in applying this measure the responsibility for compliance in both demonstrating that a loss is unrelievable, and in computing the measure of that loss for the purpose of corporation tax relief will lie entirely with the UK claimant company. This will avoid the necessity of introducing a new compliance regime for taxpayers not currently subject to taxation in the UK, and the Government is satisfied that this is proportionate.

Implementation and Delivery Plan

6.35 For a company to claim relief for losses that are unrelievable elsewhere in the EEA it will have to fill in the company tax return as usual. The only change is that it will have to tick a new box indicating that it is making one of these claims. However the company will need to be sure that the foreign loss has been correctly computed and is unrelievable in the foreign country or countries concerned. For this it may need detailed information from the surrendering company and any intermediary companies. If HMRC chooses to open an enquiry, the claimant company may be required to produce any of this information. The standard penalties and appeal process will apply.

6.36 HMRC will continue to provide the necessary education, guidance and support to operational staff who will be processing these claims and enquiries.

Monitoring and Evaluation

6.37 An extra box will be inserted onto the company tax return (CT600C) form. This will enable HMRC to identify all claims relating to this measure. The Government will therefore be able to monitor any claims and see whether this measure is correctly targeted. In due course HMRC will also undertake a review of the requirements placed on companies in Standard Cost Methodology terms.

Summary and Recommendation

6.38 This measure will:

- mitigate some of the risks arising from commercial failure for UK companies doing business through EEA subsidiaries, and
- ensure that the UK's group relief rules comply with Community law as it currently stands.

6.39 By introducing legislation in the 2006 Finance Bill the Government is taking the earliest opportunity to give the necessary clarity to business.

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REGULATORY IMPACT ASSESSMENT**Corporation Tax – Extension of Group Relief****Statement of Ministerial Approval**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 8 March 2006

7

REGULATORY IMPACT ASSESSMENT FOR NORTH SEA TAXATION

REFORM OF THE NOMINATIONS SCHEME AND RULES FOR DEALING WITH BLENDED OILS

Purpose and Intended Effect

The Policy Objectives

7.1 There is evidence of distortion to the commercial decision making process of companies for tax driven opportunities that the current legislation provides. The objectives of the proposed changes are to reduce compliance costs and provide a tax neutral environment in which commercial decisions are taken.

7.2 Changing the rules of the Nominations Scheme and thus reducing the scope for tax spinning will reduce the level of tax loss to the Exchequer. Changing the tax treatment of co-mingled oil will also reduce tax lost by preventing the opportunity to lift from non Petroleum Revenue Tax (PRT) fields, or substitute bought in oil when the oil price is high and from PRT fields when the price is lower.

Background

7.3 Profits arising from the extraction of oil and gas in the North Sea are liable to a special tax regime:

- Petroleum Revenue Tax (PRT) – charged at 50% on the net income of fields given development consent before 1993.
- Ring Fenced Corporation Tax (RFCT) – charged at 30%. The ring fence is a concept that retains the profits from the extraction of oil and gas in the North Sea inside the “fence” and prevents them being diluted with losses etc from other activities.
- Supplementary Charge (SC) – charged at 20% on ring fence profits chargeable to CT.

7.4 The normal logic of business is to realise the highest possible price for a product but because ring fence profits are taxed at a marginal rate of 75% or 50% (dependant on whether the field is subject to PRT or not) there is an incentive to try and move profits outside the ring fence into trading operations so they are taxed at the UK standard rate of 30% or to shift income and/or assets from PRT paying fields to non PRT paying fields so they are taxed at 50% rather than 75%.

Rationale for Government Intervention

7.5 Some companies chose to try and limit their liability to PRT and RFCT by indulging in a practice known as tax “spinning”. Legislation introduced in 1987 (the Nominations Scheme) and then strengthened in 1994, sought to limit scope for spinning but it has become clear that significant tax is still lost on an annual basis.

7.6 The Government is concerned that the current oil taxation legislation allows companies too much scope to select the price of North Sea oil on which they will be taxed. Not all companies take advantage of the current legislation but those who do

cause significant loss of tax to the Exchequer. This means that not only is the Government receiving less than its full share of the benefits of North Sea Oil but by allowing this behaviour to continue, it is failing to create a level playing field for all North Sea companies.

Consultation

Within Government

7.7 Consultation has taken place with:

- HM Revenue and Customs sector specialists and analysts;
- HM Treasury; and
- Department of Trade and Industry.

Public Consultation

7.8 As oil is such a specialised industry and has a specific system of taxation, full consultation was deemed inappropriate. A discussion document was sent to the oil industry and other interested parties in July 2005. Following on from this, a series of meetings have taken place with representative bodies, individual oil and gas companies, oil traders and price reporting agencies. Written representations have also been received. There has been a general acceptance that the Government's proposals are a proportionate and workable response and a number of helpful suggestions on the details of the new rules have been adopted.

Options

1. Do Nothing

7.9 The ability to minimise tax has been recognised as a feature of the legislation as it stands. A recent review of how the nominations procedures operate indicates that manipulation of the current rules is resulting in around £45 million a year, on average, lost tax to the Exchequer, rising in line with higher prices and/or a volatile market. The tax driven opportunities for allocating oil to specific fields at terminals or even replacing delivery of equity oil with oil bought from third parties is resulting in a further £35 million a year lost tax.

7.10 The fact that transactions of some oil companies appear to be tax driven rather than made for pure commercial reasons leads to the conclusion that there is a sound case for seeking to eliminate or substantially reduce the amount of tax currently being lost. The Government is committed to achieving a fair share of North Sea profits and to providing a level playing field for investors. The legislation as it currently stands is not achieving these objectives.

2. Taxing all North Sea Sales at Market Value

7.11 The BFO forward market enables producers of Brent (or potentially Forties) blend to open successive forward positions, which may be many more than are required to dispose of equity oil. (BFO is a forward contract giving the seller the option to sell Brent, Forties or Oseberg crude.) They can then chose the lowest priced sale to match to their equity to minimise the value of the sale on which they will be taxed at the

full marginal rate. This is known as tax “spinning”. Spinning is a phenomenon of the Brent forward market and arises from the fact that sales do not have to result in the physical delivery of oil.

7.12 The Nominations Scheme was introduced in 1987 and amended in 1994. It attempted to restrict the opportunity to spin by requiring companies to notify sales of equity crude to HM Revenue and Customs within a specified time (5pm on the next business day). If they fail to do this they are taxed to PRT on the monthly market value if this is higher than the realised price.

7.13 But in a volatile or falling market, companies can enter successive contracts and delay nominating a contract until the lowest point in the price cycle thus capturing the lowest possible price for their equity production and enabling them to be consistently taxed within the ring fence on an amount lower than the average market value for such deliveries. Not all companies engage in tax spinning but where they do so a considerable tax advantage can be achieved.

7.14 Moving to a system where all North Sea sales were taxed at a market value would solve both the scope to pick and chose between arm’s length and non arm’s length sales and the tax spinning issue. This approach would be controversial, as arm’s length sales would be taxed on a different value to what is actually achieved in the market. It could be especially penal to those companies who do not have the opportunity to spin or to manipulate the price on which they pay tax.

3. Tax all Equity Sales on the Brent Forward Market at Market Value

7.15 This would achieve a similar result to option 2, but would represent a more focused approach.

7.16 The potential risks to the Brent market of implementing either option 2 or 3 have been considered. While the market in forward Brent paper contracts was originally mainly tax driven, once the market was up and running these contracts became instruments for speculation and hedging.

7.17 However, there are now a large range of financial instruments that perform these tasks and arguably the Brent forward market is no longer essential for this purpose, although tax driven practices are no doubt contributing to the liquidity of the Brent market. Furthermore, some producers may be reluctant to enter the forward market for sale of their production where the tax price was other than the realised price. There is therefore a risk that implementing option 2 or 3 may have an impact on the market.

7.18 Some contributors to discussions have suggested the changes would result in a scenario where liquidity in the Brent market would reduce to such an extent that the market would collapse and undermine the credibility of the International Exchange (ICE) futures contract that is settled off the forward market price. This could destabilise Brent crude’s position as the world’s most widely used crude marker price, with consequent movement of oil futures trade away from the UK.

7.19 Following extensive debate on this issue with market consultants and other interested parties, the Government is unconvinced of the strength of this argument but acknowledge that the risk exists. Option 4 was therefore developed to achieve the same outcome, whilst minimising commercial risk.

4. Tighten up the current nominations scheme rules and apply nominations excess to RFCT and SC

7.20 The time limit for nominating sales to HM Revenue and Customs is 5pm on the day of business following the date of the contract, where the company wants to fix the price on which it is taxed. Under the scheme rules, any equity sales volumes in a month that have not been nominated will be subject to Petroleum Revenue Tax (PRT) on both the realised price and, where higher, the excess of the market value of that oil for that month over the realised price. Such excess is known as a nomination excess.

7.21 The scheme therefore provides a simple mechanism for companies to achieve certainty on the PRT tax price on fixed price contracts in the forward market provided they deliver their oil through the contract nominated. Under current rules, a nomination excess is only chargeable to PRT so companies with field interests not liable to PRT (post 1993 fields or those where fields are covered by reliefs or allowances) are still free to tax spin on sales of oil and thus benefit from lower ring fence prices for CT and SC. The tax saving is less in these cases than for PRT paying fields but can still be considerable.

7.22 For the Nominations Scheme to achieve its policy objective of curtailing tax spinning the Government believes it is necessary to make the nominations excess liable to RFCT and SC as well as PRT. If the scope is not extended, it is still possible that companies will simply not bother to nominate where they have the ability to tax spin and pay PRT on nomination excesses from their PRT fields while enjoying the benefit of lower prices for RFCT and SC in respect of their whole production. Therefore, nomination excesses will be subject in full to the appropriate North Sea tax rates whether or not particular fields are liable to PRT.

7.23 Bringing forward the time for nominations by 24 hours to 5pm on the date of the contract would reduce the scope for choosing lower priced contracts but would not solve the problem entirely. Requiring companies to nominate immediately on entering a contract would remove the scope but could be difficult to police.

7.24 Therefore a time limit of 2 hours for nominating from entering a deal has been chosen to meet the objectives of stopping tax spinning, allowing companies sufficient time to enable them to properly nominate a deal and enabling HMRC to police the system.

7.25 The scope of the scheme will also be limited to sales made through forward contracts. This will prevent sales where there is no risk of tax spinning from being caught by the amended legislation and so will result in the need for fewer nominations overall. No risks associated with this option have been identified.

5. Introduce Rule to Address the Allocation of Oil not in line with Entitlement

7.26 This problem arises where large producers have interests in more than one field contributing to a particular blend. Although it is different from the problem of tax spinning and the options to solve this outlined above, it is part of the larger problem of tax driven behaviour, which these measures seek to address. While some fields may be liable to PRT, others may not and in these circumstances companies will allocate their lifting at the terminal point from non PRT fields when the oil price is high and from PRT fields when the price drops, thus reducing their tax liability.

7.27 In addition to this, they may buy oil from small producers under month of entitlement contracts and substitute this oil for their own equity oil when oil prices are high. Oil purchased from another producer and any subsequent sale of this oil is treated as trading in oil rather than the production of oil and is therefore outside the ring fence and only subject to 30% tax. Rules announced at PBR 05 to change the way in which oil for non arm's length disposals is valued from 1 July 2006 will go some way to reducing the tax advantage from these strategies but further action is still needed.

7.28 Introducing rules to ensure that the tax treatment of oil lifted is in accordance with field entitlement would remove the tax benefit for companies in allocating cargoes to particular fields or to substitute purchased oil out of line with entitlement in an attempt to optimise their tax position.

7.29 Large producers were paying a premium to small producers (up to \$1 per barrel) in return for the flexibility of lifting additional oil at a time when oil prices are high. This premium may reduce following revised legislation to the extent that it represents a share in the tax savings derived from buying and selling oil in this way.

Sectors and Groups Affected

7.30 With the exception of options 2 and 3, the options set out above will affect only 120 or so entities undertaking oil and gas exploration activities in the UK and UK Continental Shelf. It is unlikely that other particular groups or companies would be affected. Options 2 and 3 may have a much broader impact on the workings of the Brent market and consequent ripple effect to market traders, dealers and exchanges.

7.31 There are no environmental or social cost impacts to any of the options. There are no impacts on:

- rural communities;
- voluntary organisations and charities;
- human rights; and
- devolved administrations.

7.32 Any impact to markets from option 2 or 3 is likely to impact London more than any other region of the UK due to the location of market traders and the Intercontinental Exchange.

7.33 There are no specific equality issues but the need for change is driven by the desire to create a level playing field for all companies investing in the North Sea.

Costs and Benefits

1. Do Nothing

7.34 Loss of tax from tax spinning and optimisation strategies for allocating oil at terminals is estimated at up to £ 80 million a year which would be lost to the Exchequer under the do nothing option.

7.35 The do nothing option imposes no additional costs on companies. But UK citizens generally will be affected by the continuing loss of tax to the Exchequer from the do nothing option and the North Sea playing field will remain uneven.

2. Taxing all North Sea Sales at Market Value

7.36 By imposing a market value on all equity sales of North Sea oil, companies could be taxed on quite different amounts to what they actually realise on their sales.

7.37 This option should recover 100% of the tax at risk from tax spinning, so recovering on average £45 million per year. It would remove the need for the Nominations Scheme altogether. The Nominations Scheme currently imposes a high compliance burden on companies that engage in tax spinning and also on those who fall within the scope of the scheme but do not spin. Implementing this option would therefore contribute to the Government's aim of reducing the regulatory burden on business.

3. Tax all Equity Sales on the Brent Forward Market at Market Value

7.38 Applying a market value to all equity sales through the Brent forward market would impact on any oil company engaged in this behaviour but the price of equity oil delivered under these contracts does not reflect the true value of oil for that delivery period. This difference is currently made up by the Exchequer (and hence the UK population) in terms of lost tax.

7.39 On its own, this option would recover around £45 million a year. It would also obviate the need for the Nominations Scheme as discussed above.

4. Tighten up the current nominations scheme rules and apply nominations excess to RFCT and SC

7.40 Tightening the Nominations Scheme will not involve companies maintaining any additional records from the ones they already need to keep to comply with the legislation. However, reducing the scope of the scheme greatly reduces the number of sales that require nomination so the burden of nomination will be entirely removed from a lot of companies and those who do still need to nominate will do so in much more limited circumstances.

7.41 There are currently around 380 nominations per year and it is estimated that under the new legislation this will reduce to around 40 per year. This is in line with Government's commitment to reduce the regulatory burden on companies wherever possible.

7.42 Tightening the nominations scheme would recover a proportion of the amount lost from tax spinning (£45 million a year). The shorter the time limit the less that would remain at risk. The Government would expect to recover most, if not all of the £45 million from implementing this option with a two hour time limit.

5. Introduce Rule to Address the Allocation of Oil not in line with Entitlement

7.43 Developing legislation to ensure that equity oil is taxed in accordance with the co-mingling agreements will reduce arbitrage opportunities and could lead to some of the larger companies reducing the premium they were prepared to pay smaller companies for term deals (where oil is sold at a pre-determined price for delivery over a

period extending beyond one month). But to the extent that these premiums result from tax driven behaviour the impact of their removal should be disregarded.

7.44 Companies already need to keep records to decide how to allocate their oil. In future, they will use the same information to calculate the allocation of oil for tax purposes. This will include a degree of extra work for companies with a lot of field interests and month of entitlement oil, to ensure compliance with the rules. Some of the terminal systems as presently configured would require the generation of large quantities of documentation in complying with the rules. As these documents need to be examined and signed off before the oil is loaded this could potentially impact upon terminal operators.

7.45 In the short term, it is likely that companies with a large number of field interests will need to run a separate tax allocation record in addition to the commercial one. Running parallel systems will impose an increased regulatory burden on the small number of companies involved.

7.46 The tax advantages arising from the mix of PRT and non PRT fields and the bought in oil arise from judging when it is most tax advantageous to attribute a lifting amongst the various sources of oil. The more certain you are of tax prices on different lifting dates, the bigger the tax gain.

7.47 Under the changes already announced at Pre-Budget Report to the way in which we calculate a market value for tax, it will be more difficult for companies to judge which sources of oil to attribute to their different non arm's length transactions. Accordingly, some of the £35 million a year tax at risk will already be recovered by the proposed move to value non arm's length disposals of oil on a daily rather than a monthly average price.

7.48 It is not totally clear of the extent to which allocation of lifting to fields not in accordance with co-mingling agreements takes place but the remainder of the tax estimated to be at risk should be recovered by introducing this measure. The £35 million figure is net of the estimated reduction in tax from smaller companies on the assumption that the month of entitlement premiums paid by the larger companies are reduced in light of the loss of tax benefit.

7.49 Figures below are based on 2004 analyses and reflect what could be recovered for 2006/07 in relations to each the option implemented.

Table 7.1 Option recovery if implemented

Option 1	Option 2	Option 3	Option 4	Option 5
(£80m)	£45m	£45m	£45m	£35m

Small Firms Impact Test

7.50 The options described above apply equally to large and small companies and as a result there are no specific small firms issues.

Competition Assessment

7.51 A competition assessment has been undertaken and the filter has been applied to each option. This indicated that reforming the oil tax rules should not have any

adverse effects on the highly specialised activity of companies who sell oil they have won from the North Sea into the highly competitive and buoyant world market.

7.52 Not all companies have the opportunity to use the planning techniques described here and of those that do, some choose not to. By implementing some of the options outlined in this document the Government is creating a level playing field for companies in the North Sea by removing or refining tax rules that are distorting commercial decisions.

7.53 Research and internal consultation to date have concluded that there may be some impact on the Brent futures market because some transactions that are purely tax driven may disappear. HM Revenue and Customs have listened to industry concerns over this issue and believe the impact of the proposed option is likely to be negligible.

Enforcement, Sanctions and Monitoring

7.54 The preferred options would be defined in primary legislation with the detail in Regulations. The legislation will be enforced via the normal risk assessment process. Sanctions would be through the statutory interest and penalty provisions as defined in the Finance Acts.

7.55 The information returned by companies is subject to routine analysis by HM Revenue and Customs operational caseworkers to ensure the correct amount of tax is collected. The results of any legislation and any resultant changes in behaviour would be monitored as part of this process to ensure no further tax is at risk.

Implementation and Delivery Plan

7.56 The legislation to be published in the Finance Bill is the result of long and detailed discussions with the oil industry representative bodies, individual oil companies and affected parties. The changes will take effect from 1 July 2006, which should allow companies the time to make the necessary changes to systems and procedures. Full instructions will be published in the Oil Taxation Manual prior to the changes taking place. In due course HM Revenue and Customs will also undertake a review of figures in this RIA in Standard Cost Methodology terms.

Post-implementation Review

7.57 Nominated prices for oil will be monitored against actual arm's length sales to note price variant and HM Revenue and Customs will repeat the analysis carried out for earlier years to see if the pattern has changed. An analysis of the amounts of oil at the terminal allocated across field interests will determine whether legislation on this issue has been successful.

Summary and Recommendation

7.58 It is recommended that options 4 and 5 are adopted. Although options 2 and 3 would achieve the same results in terms of tax, the level of risk to the stability and sustainability of the Brent market is unacceptable.

7.59 Option 4 should recover the same amount of tax without the associated risks. HM Revenue and Customs will continue to review outcomes to ensure tax spinning is limited and will take further action if necessary.

7.60 Option 5 (coupled with the move to change the way in which HM Revenue and Customs value oil for non arm's length transactions) should stop tax driven behaviour at terminals. Although there may be an impact on smaller oil companies, this will be through the removal of a subsidy paid to them by larger companies for the purposes of lowering their tax bills. This means that the Exchequer is receiving less than its full share of the benefits of the North Sea.

Table 7.2 Summary Costs and Benefits

Option	Total benefit per annum: Economic, Environmental, and Social	Total cost per annum: Economic, Environmental, Social, Policy and Administrative
1	£80 million tax loss	Nil
2	£45 million tax	Nil
3	£45 million tax	Nil
4	£45 million tax	Nil
5	£35 million tax	Nil

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REGULATORY IMPACT ASSESSMENT**North Sea Taxation – Reform of the Nominations Scheme
and Rules for Dealing with Blended Oils****Statement of Ministerial Approval**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 14 March 2006

REGULATORY IMPACT ASSESSMENT FOR REFORM OF THE NORTH SEA OIL TAX PRICING RULES

Purpose and Intended Effect of the Measure

The Policy Objective

8.1 There is evidence of distortion to the commercial decision making process of companies for tax driven opportunities that the current legislation provides. The objectives of the proposed changes are to provide a tax neutral environment in which commercial decisions are taken, so reducing the scope for tax manipulation and reducing the level of tax loss to the Exchequer.

Background

8.2 Profits arising from the extraction of oil and gas in the North Sea are liable to a special tax regime:

- Petroleum Revenue Tax (PRT) – charged at 50 per cent on the net income of fields given development consent before 1993;
- Ring Fenced Corporation Tax (RFCT) – charged at 30 per cent. The ring fence is a concept that retains the profits from the extraction of oil and gas in the North Sea inside the “fence” and prevents them being diluted with losses etc from other activities; and
- Supplementary Charge (SC) – charged at 20 per cent on ring fence profits chargeable to CT (before finance charges).

8.3 The normal logic of business is to realise the highest possible price for a product but because ring fence profits are taxed at a marginal rate of 75 per cent or 50 per cent (dependant on whether the field is subject to PRT or not) there is an incentive to try and move profits outside the ring fence into trading operations so they are taxed at the UK standard rate of 30 per cent.

8.4 The general principle underlying the current rules for pricing UK oil for taxation purposes is that the actual realised price is taken for oil sold at arm’s length (to third parties) and a monthly market value (determined by HM Revenue and Customs) is applied to non arm’s length sales and transfers to their own refineries.

Rationale for Government Intervention

8.5 There are inherent problems with the monthly valuation in current legislation, which provides an opportunity (particularly in volatile markets) to arbitrage between arm’s length and non-arms length disposals to achieve the lowest price for tax purposes. A further arbitrage opportunity arises in a rising market, where the market value fails to keep up with the actual price of oil.

8.6 The Government is concerned that the current oil taxation legislation allows companies too much scope to select the price of North Sea oil on which they will be taxed causing significant loss of tax to the Exchequer. This means that not only is the Exchequer receiving less than its full share of the benefits of North Sea Oil but by allowing this behaviour to continue, the Government is failing to create a level playing field for all North Sea companies.

Consultation

8.7 Within Government, consultation has taken place with:

- HM Revenue and Customs sector specialists and analysts;
- HM Treasury; and
- Department of Trade and Industry

Public Consultation

8.8 As oil is such a specialised industry and has a specific system of taxation, full consultation was deemed inappropriate. A discussion document was sent to the oil industry and other interested parties in July 2005. Following on from this, a series of meetings have taken place with representative bodies, individual oil and gas companies, oil traders and price reporting agencies. Written representations have also been received. There was a general acceptance that the Government's proposals were a proportionate and workable response and a number of helpful suggestions on the details of the new rules have been adopted.

Options

1. Do Nothing

8.9 The ability to minimise tax has been recognised as a feature of the legislation as it stands but the amount of tax being lost was not deemed to be significant. However, a recent review of the way the valuation procedures operate indicates that manipulation of the current rules is resulting in around £80 million a year, on average, lost tax to the Exchequer, rising in line with higher prices and/or a volatile market.

8.10 The fact that transactions of some oil companies appear to be tax driven rather than made for pure commercial reasons leads to the conclusion that there is a sound case for seeking to eliminate or substantially reduce the amount of tax currently being lost. The Government is committed to ensuring oil companies receive a fair post-tax return for their risk and investment in the North Sea and the UK gets a fair share of the revenues derived from what is a national resource. The Government is also committed to providing a level playing field for companies investing in the North Sea. The legislation as it currently stands is not achieving these objectives.

2. Change the basis of calculation for the market value from a month based on a 6 week reference period to a daily value based on 5 days around the bill of lading

8.11 Under current rules, a monthly market value is applied to all non arm's length sales of oil. It is calculated by averaging a daily average of all sales over a six week period (the valuation reference period) beginning at the start of the month prior to delivery and ending in the middle of the month of delivery.

8.12 Setting a market value for a one month period means that the price is rarely likely to reflect the actual value of oil at the time of delivery, especially in a volatile market. It also means that companies can predict with some accuracy what the market value is likely to be and to decide whether to sell their oil at arm's length or non arm's length according to which will produce a lower tax bill. They will sell arm's length when

they expect the monthly market value to be higher than their realised price and non arm's length when they expect the monthly market value to be lower than the realised price.

8.13 To make the system tax neutral it is necessary to ensure that the amount taxed for arm's length and non arm's length sales are similar, especially as the general taxation principle of arm's length sales is that the market value of goods for delivery at any given time should reflect prices for sale on the open market at that time. The reason for the divergence of prices in the North Sea is due to the fact that a monthly average value cannot reflect the price of specific cargoes unless the price of oil is static. This means that there can be significant tax loss in volatile, rising and falling markets.

8.14 A daily value for oil could be achieved by taking an average of the daily prices for the actual date of the bill of lading (the document issued by the carrier which is evidence of the receipt of goods and a contract of carriage) and two days either side. This would provide a more realistic market price and remove the opportunity for companies to choose whether to sell arm's length or non arm's length by "second guessing" what the monthly value would be.

3. Change the basis of calculation for the daily market value to a period greater than 5 days but less than 6 weeks or use a different 5 day period

8.15 As in option 2 but using a longer reference period than 5 days to calculate an average, for example 0-0-10 or a different 5 day period 0-0-5.

Sectors and Groups Affected

8.16 The options set out above will affect only 120 or so entities undertaking oil and gas exploration activities in the UK or UK Continental Shelf. It is unlikely that any other particular groups or companies would be affected.

8.17 There are no environmental or social cost impacts to any of the options. There are no specific impacts on:

- rural communities;
- voluntary organisations and charities;
- human rights;
- devolved administrations; and
- particular regions of the UK.

8.18 There are no specific equality issues, but the need for change is driven by the desire to create a level playing field for all companies investing in the North Sea.

Option 1

8.19 UK citizens generally will be affected by the continuing loss of tax to the Exchequer from the do nothing option and the North Sea playing field will remain uneven.

Option 2

8.20 This option reduces the scope to choose between arm's length and non arm's length sales for tax driven reasons and so produces a tax neutral regime. Moving to a daily market value means that the market value reflects the actual value of oil at any given point. As such, the regulatory impact on oil companies should be negligible or even reduced and they will be able to hedge any risks with certainty.

Option 3

8.21 This option would also produce a daily value based on a shorter period, as such the impact would be similar to option 2. Companies might find it easier to hedge 0-0-10 or 0-0-5 if the delivery date is unknown but Option 2 provides the hedging certainty required and reflects the way in which most oil is sold.

Costs and Benefits

Option 1

8.22 Comparison of the monthly market value over a 6 year period 1999 – 2004 with an average of the actual arm's length nominated prices on which companies have been taxed shows an average tax loss of £80 million per year but it could be substantially more in any given year depending on market conditions and the price of oil.

8.23 The do nothing option imposes no additional costs on companies.

Option 2

8.24

Analysis suggests that around £80 million per year could be recovered by changing to a daily market value based on a 5 day reference period. Because companies already have to make a return to HM Revenue and Customs of all sales for PRT purposes, there would be no additional regulatory burden in complying with this option. Companies' administrative requirements may fall if there is no longer an incentive to engage in or resource behaviours that are causing the tax loss.

Option 3

8.25 Tax benefits are the same as option 2, although there may still be arbitrage opportunities between arm's length 2-1-2- prices and non arm's length 0-0-10 or 0-0-5 prices which could reduce the yield and are less in line with market practice.

8.26 Figures for increased tax shown below are based on 2004 analyses and reflect what could be recovered for 2006/07 and subsequent years if options 2 or 3 were implemented.

Table 8.1 Option Recovery if Implemented

Option 1	Option 2	Option 3
(£80m)	£80m	£80m (but see comments above)

Small Firms Impact Test

8.27 The options described above apply equally to large and small companies and as a result there are no specific small firms issues.

Competition Assessment

8.28 A competition assessment has been undertaken and the filter has been applied to each option. This indicated that reforming the oil tax pricing rules should not have any adverse effects on the highly specialised activity of companies who sell oil they have won from the North Sea into the highly competitive and buoyant world market.

8.29 Not all companies have the opportunity to use planning techniques described here and of those who do, some chose not to. By implementing some of the options outlined in this document the Government is creating a level playing field for companies by removing or refining tax rules that are distorting commercial decisions.

8.30 The proposed changes would help to eliminate any unfair competitive advantage accruing to companies with integrated off-shore oil extraction and on-shore refining activities who by being able to switch between selling arm's length (to third parties) or non arm's length (into their own refineries) can reduce their exposure to tax. In so far as the changes may eliminate opportunities for switching, they will also reduce administrative costs for companies engaged in such activity. In turn, it may also be possible to reduce regulatory burdens.

Enforcement, Sanctions and Monitoring

8.31 The principles of option 2 or 3 would be defined in primary legislation with the detail contained in Regulations. The legislation will be enforced via the normal risk assessment process. Sanctions would be through the statutory interest and penalty provisions as defined in the Finance Acts.

8.32 The information returned by companies is subject to routine analysis by HM Revenue and Customs operational caseworkers to ensure the correct amount of tax is collected. The results of any legislation and any resultant changes in behaviour would be monitored as part of this process to ensure no further tax is at risk.

Implementation and Delivery Plan

8.33 Draft legislation will be issued before the Budget to allow time for further comment from industry, with changes commencing from 1 July 2006. This provides adequate time for companies to make any necessary changes. Full instructions will be published in the Oil Taxation Manual. In due course HM Revenue and Customs will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Post-implementation Review

8.34 HM Revenue and Customs calculations of the oil price for NAL sales will be monitored against values of AL sales for comparison. We will repeat the analysis we carried out for earlier years to see if the pattern has changed.

Summary and Recommendation

8.35 It is recommended that option 2 is adopted as it mirrors the way in which oil is actually sold. Option 1 would not achieve the objective of ensuring the Government receives its' full share of the benefits of North Sea Oil and creating a level playing field for all North Sea companies. While option 3 would potentially achieve a similar outcome to option 2, it does not reflect the way in which the majority of North Sea oil is sold and still leaves open the risk of tax arbitrage opportunities for companies to exploit. HM Revenue and Customs will continue to review the pricing terms of market contracts with a view to moving the market value to either 0-0-10 or 0-0-5 should either of those become the market norm.

Table 8.2 Summary Costs and Benefits

Option	Total benefit per annum: Economic, Environmental, and Social	Total cost per annum: Economic, Environmental, Social, Policy and Administrative
1	£80 million tax loss	Nil
2	£80 million tax	Nil
3	£80 million tax	Nil

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REGULATORY IMPACT ASSESSMENT
Reform of the North Sea Oil Tax Pricing Rules
Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 14 March 2006

REGULATORY IMPACT ASSESSMENT FOR REDUCED RATE OF VAT (5%) FOR CONTRACEPTIVE PRODUCTS

Purpose and Intended Effect of Measure

The Policy Objectives

9.1 To reduce the price of contraceptive products, consistent with the Government's broader sexual health strategy of:

- promoting access to contraceptive products and advice where appropriate; and
- supporting people in making better, more informed, choices for the protection of their own sexual health.

9.2 In doing so, to increase access to the sexual health benefits of contraceptive products for people across the UK for whom price is currently an obstacle.

Background

Present VAT Treatment of Contraceptive Products

9.3 VAT is not chargeable when a product is provided free of charge – for example by the NHS.

9.4 VAT is also not chargeable to individuals on prescribed contraceptive products supplied by a pharmacist (such as the contraceptive pill),¹ nor where a contraceptive product is fitted or administered in a hospital or clinic.²

9.5 However, VAT is chargeable at the standard rate (17.5 per cent) on all other sales of contraceptive products, including on all sales made 'over the counter' by way of retail, internet sales, or sales made from vending machines.

Government Strategy on Sexual Health

9.6 In its November 2004 White Paper 'Choosing Health: Making health choices easier', the Government announced £300 million would be allocated over three years to transform and improve sexual health. More recently sexual health has been designated one of the top NHS priorities for 2006-07.

9.7 Measures announced to date include a high-profile national campaign aimed at increasing awareness of sexually transmitted infections (STIs) and promoting the protective benefits of condoms. The Government has also committed funding for the improvement and upgrading of NHS genito-urinary medicine (GUM) and contraceptive services, and for a National Chlamydia Screening Programme.

The Market for Contraceptives

9.8 Sales of condoms account for 99 per cent of all 'over the counter' sales of contraceptives³. Therefore the major impact of any VAT reduction will be in relation to

¹ This supply is zero-rated under item 1, Grp 12, Schd 8, VAT Act 1994.

² This supply is exempt from VAT under item 1 or 4, Group 7, Schd 9, VAT Act 1994

the sale of condoms. Analysis in this RIA therefore focuses on condoms, in relation to which, research⁴ prepared for the Department of Health in January 2005 found that:

- An estimated 126 million condoms are purchased or made available annually in the UK. Within this, 60.7 per cent are purchased from retail outlets, 7.9 per cent are purchased from vending machines, 1.2 per cent are purchased from internet retailers and 30.2 per cent are provided free of charge by the NHS and others.
- Condom prices vary from approximately 23p to £2.13. Average (mean) retail price is 60-65p, while the average (mean) price from vending machines is 67p - £1.
- Larger supermarkets and pharmacy chains generally dominate the retail market for condoms. However, condoms are also sold through outlets such as petrol stations, convenience stores and vending machines, where competitive pressure on price may be less significant.
- The sample of manufacturers and retailers surveyed believe that price, accessibility and safety are the key factors of importance to consumers when purchasing condoms. Price was thought to be a particularly significant factor for some of the most vulnerable sexual health risk groups, and any price reduction could therefore have its major impact on condom purchase and use amongst these groups.
- Assuming that a VAT reduction from 17.5 per cent to 5 per cent was passed on in full within prices, sales of condoms could increase by up to one million for two years. However a price reduction is likely to achieve its best results (in terms of increasing condom use) when introduced alongside broader measures designed to promote and improve access to condoms.

Rationale for Government Intervention

9.9 The Government has committed funding for a range of measures designed to improve and modernise sexual health services, and to support people in making better-informed choices for their own sexual health. Measures enacted or planned include: improved access to NHS sexual health and contraceptive services; a National Chlamydia Screening Programme; and a health education campaign aimed at increasing awareness of STI risks.

9.10 As well as the benefits to be achieved in terms of an individual's health and wellbeing, there is also a broader economic argument to support Government investment in sexual health and contraceptive services. Research by FPA (Family Planning Association) suggests that for every £1 spent on providing wide availability to good contraception there is a corresponding saving of over £10.⁵

³ All analysis in this section of the RIA is reproduced from *OTC Contraceptives – UK Market Study - A Report for Department of Health* carried out by Sambrook Research International (31 January 05). This included desk research and interviews with a small sample made up of 27 manufacturers, retailers and other relevant groups. Where relevant, these data will be published by Department of Health.

⁴ *ibid*

⁵ McGuire A and Hughes D (1995) cited in Independent Advisory Group on Sexual Health and HIV Response to New Developments in Sexual Health and HIV AIDS Policy (February 2006)

9.11 The Government is also aware of the views of the Independent Advisory Group for Sexual Health and HIV, and a number of other expert groups, which have supported a VAT reduction as an effective part of the Government's sexual health strategy.

9.12 The Government believes that any VAT reduction would be most effective alongside broader measures - both from Government and elsewhere - aimed at promoting awareness of sexual health risks and contributing to the prevention of STIs. At the same time, sexual health awareness-raising measures, such as the planned nationwide campaign, will be most effective where individuals can obtain access to affordable contraceptives.

9.13 A VAT reduction and broader measures to raise sexual health awareness should therefore be mutually enhancing, and a wide range of organisations - including the NHS, sexual health charities and manufacturers and retailers of contraceptive products - have a role to play in securing improvements in sexual health.

9.14 Retailers of condoms have campaigned for a VAT reduction, and a number of retailers have already undertaken to pass any such VAT reduction on to customers within retail prices. The Government believes that all suppliers should follow this course of action and will monitor the position closely.

9.15 Further, the VAT reduction, when considered alongside broader Government measures to raise awareness and promote the sexual health benefits of condoms, is likely to increase sales of condoms. On this basis, the Government believes that it is reasonable to expect condom manufacturers and retailers - who can expect to benefit from increased sales - to sponsor or undertake other initiatives to support sexual health - for example through the increased provision of sexual health information, or by tackling access to condoms or information among identified sexual health risk groups. The Department of Health will explore with manufacturers and retailers the constructive role they can continue to play in improving sexual health alongside the Government's strategy.

Consultation

Within Government

9.16 Discussions between HM Treasury, HM Revenue and Customs and Department of Health about potential interactions between the VAT position and the Government's strategy to transform and improve sexual health.

Public Consultation

9.17 The Government is aware of the views of a range of stakeholders and expert groups, which have supported a reduction in the VAT rate chargeable on contraceptive products. These include the Independent Advisory Group on Sexual Health and HIV, sexual health charities, the MPs who are signatories to House of Commons early Day Motion 687, and a number of the main manufacturers and retailers of contraceptive products.

9.18 VAT on condoms is one of a number of issues relating to sexual health discussed in general terms with a sample of manufacturers and retailers by Sambrook Research International in the course of preparing a market study for the Department of Health.⁶

⁶ See footnote 3

In the course of this research, the vast majority of this sample made clear that they would pass on any VAT reduction to customers with prices, and a majority also indicated that, in addition to a price reduction, they would undertake further initiatives in support of the Government's broader strategy to transform and improve sexual health.

Options

9.19 Under the European agreements that govern the VAT system, it is not possible to entirely remove VAT from all contraceptives. It is however possible to introduce a reduced rate of VAT of 5 per cent. On that basis, available options include:

1. Do Nothing

9.20 The standard rate of VAT (17.5 per cent) would continue to be chargeable on all contraceptive products other than those that are (i) prescribed or (ii) administered or fitted in the course of medical care or treatment.

2. Five Per Cent Rate for Male and Female Condoms Only

9.21 This would reduce the VAT payable on an estimated 99 per cent of contraceptive products sold 'over the counter', but not on any other product other than condoms.

3. Five Per Cent Rate for all Contraceptive Products

9.22 This would reduce the VAT payable for all contraceptive products on which VAT is presently charged at 17.5 per cent - including male and female condoms, and (non-prescribed) diaphragms, caps and emergency contraception sold over the pharmacist's counter.

Costs and Benefits

Sectors and Groups Affected

9.23 The measure has potential benefits for a large number of people. The greatest potential benefit is for those people who wish to purchase and use contraceptives, but for whom price is currently an obstacle.

9.24 There will also be an impact on all organisations that purchase or sell contraceptive products – such as retailers, vending machine operators, internet retailers, the NHS and other health care providers.

9.25 None of the identified options would have any equality impact.

Benefits

1. Do Nothing

9.26 There would be no loss of tax revenue and no new compliance costs for any supplier of contraceptive products.

2. Five Per Cent Rate for Condoms Only

9.27 The Government expects that all retailers and manufacturers of contraceptive products will pass the benefit of any VAT reduction onto their customers in the form of lower prices. This should lead to reductions in price for individuals and organisations (such as the NHS) that purchase condoms. Using the average prices quoted above, customers could expect the price of a packet of three condoms to fall by approximately 20p, although this will of course vary according to the VAT-exclusive price charged by the supplier.

9.28 This VAT reduction should therefore increase access to condoms for people that wish to purchase and use them, but for whom price is currently an obstacle. In doing so, the VAT reduction will enhance and complement other Government measures aimed at raising awareness of sexual health risks, promoting access to sexual health advice, and supporting people in making better choices for the protection of their health.

9.29 A VAT reduction that contributes to increased access to, and usage of, condoms could impact upon the incidence of STIs and unplanned pregnancies amongst particularly vulnerable groups. As well as providing potential benefits in terms of individual's health and wellbeing, and the reduction of broader health inequalities, this could produce savings in NHS treatment costs. As detailed above, analysis suggests that every £1 spent on contraception produces a corresponding saving of over £10.⁷

9.30 It is likely that a VAT reduction, when considered alongside the Government's broader sexual health measures, will benefit condom manufacturers and retailers by increasing their sales. In return for this benefit, the Government believes that it is reasonable to expect manufacturers and retailers to play a major part in supporting sexual health improvements. The Department of Health will discuss with the major manufacturers and retailers the further sexual health benefits that might be achieved through industry initiatives, which might be undertaken alongside the planned Government measures.

9.31 Restricting a reduced VAT rate to condoms would recognise that fact that condoms are commonly regarded as the most effective contraceptive safeguard against STIs. It is therefore the Option that could provide the most effectively targeted benefits in relation to the prevention of STIs.

3. Five Per Cent for all Contraceptive Products

9.32 This option would result in the same general benefits, and the same beneficiaries, as are outlined in respect of Option ii. It would however also remove any risks associated with different retailed contraceptive products being treated differently for VAT purposes – for example, the risk that different VAT treatment might impact on customer choice, or contribute to VAT accounting complexities for retailers.

⁷ see footnote 2

Costs

Revenue Costs

1. Do Nothing

9.33 The Government's broader strategy to promote informed decision making in relation sexual health may be less effective, especially in relation to those people for whom price is currently an obstacle to accessing contraceptives.

2. Condoms Only

9.34 The fiscal cost of this option is approximately £6 – 7 million per year.

3. Reduced Rate for all Contraceptive Products

9.35 The fiscal cost of this option is approximately £10 million per year.

Compliance Costs for Businesses

9.36 The tax compliance burden associated with any change (Options 2 and 3) will fall on retail, internet or vending machine suppliers, both large and small. Most – if not all – of this cost is likely to be one-off and could arise from:

- the need for retailers to make changes to their Epos systems and VAT retail schemes;
- the need for vending machine operators to make adjustments to their machines; and
- the complexity for suppliers that might – under option ii - have to apply different VAT rates for contraceptive products.

9.37 The overall cost to businesses is expected to be below £3m. In relative terms large multiple chains will be less affected than the small independent chemist. For large multiple chains (such as supermarkets) the cost will not be significant, while for smaller suppliers the estimated costs are set out in section 6: 'The Small Firms Impact Test' and, we estimate, should not be higher than £0.7m in total.

9.38 When considering any costs, it is fair to recognise that most affected suppliers will already apply a 5 per cent VAT rate for women's sanitary products, and therefore will have the necessary systems in place to account for sales made at the 5 per cent rate of VAT. This may well reduce any costs associated with this VAT change. Further, any costs will be offset wholly or in part by the revenue gained from additional sales generated by a VAT reduction.

Small Firms Impact Test

9.39 Our assessment of the compliance costs associated with a reduced rate of VAT is set out in the table below. The difference in compliance costs between the two reduced rate options (Options 2 and 3) is considered to be insignificant.

Table 9.1 Compliance Costs

Set Up Costs		
Independent Chemists	Total	£0.11 million
	Each	£15
Vending Machines	Total	£0.58 million
	Each	£10
Internet Suppliers	Total	£0.01 million
	Each	£10

Competition Assessment

1. Do Nothing

9.40 No competition effect.

2. Condoms Only

9.41 Will provide a VAT benefit for the major part of the retailed contraceptive market. However, it is unlikely that price considerations alone influence consumers to choose one form of contraception over another.

3. All Contraceptive Products

9.42 No competition effect anticipated.

Enforcement, Sanctions and Monitoring

9.43 If non-compliance is established this will be dealt with under powers given in VAT Act 1994.

9.44 The Government expects all manufacturers and retailers to pass on any VAT reduction within prices, and, will closely monitor the effects of this tax change on prices. This will inform our review of the proposed measure, which will take place one year after the changes have taken place.

Implementation and Delivery Plan

9.45 Guidance for businesses affected by the proposed VAT change will be published by HMRC in the form of a Budget Note, issued on 22 March 2006. HMRC have also publicised the proposed VAT change through their advice and contact centres for businesses and the public.

9.46 The measure will be implemented by statutory instrument during 2006 to come into effect, subject to Parliamentary approval, on [1 July 2006]. This will allow a sufficient lead-in for manufacturers and retailers to prepare for the price changes that should result from a VAT reduction.

Post Implementation Review

9.47 The Department of Health will discuss with manufacturers and retailers the expected impact of this proposed VAT reduction in terms of reduced prices for customers, and other industry initiatives designed to support sexual health and improve access for those that require contraceptive products.

9.48 The Government will monitor the impact on prices and access to contraceptive products, and the response of the industry to the VAT reduction:

- as part of its post-implementation review, which will take place within one year after the proposed changes have been implemented; and
- in the course of its ongoing strategy to transform and improve sexual health.

Summary and Recommendation

9.49 Option 3 - A VAT reduction for all contraceptive products is recommended.

Table 9.2 Option 3 Recommendation

Costs	Benefits	
Revenue cost to Exchequer of approximately 10m p.a.	Mutually enhance existing Government strategy to promote sexual health benefits of contraceptive products, and informed decision making.	
No significant costs for major retailers		
Estimated overall one-off set up costs for smaller businesses of no more than 0.7million		Benefits to be expected in individual well-being if contraceptive products are more widely available for those that wish to use them, and for whom price is presently an obstacle
However any costs will be wholly or partly offset by increased revenue generated by increased sales.		Research suggests that for every £1 spent on providing wide availability to good contraception there is a corresponding saving of over £10.

9.50 This represents a cost-effective proposal, fully supported by (and supportive of) the Government's sexual health strategy, including its promotion of the sexual health benefits of condoms. The evidence presented above supports this recommended option on the basis of:

- the sexual health benefits of condoms in the reduction of STIs and unplanned pregnancies;
- the expectation that a VAT reduction will be reflected in reduced prices and will complement existing Government measures to promote sexual health and informed decision-making; and
- the suggestion that the price of contraceptive products is currently an obstacle to access to, and use of, contraceptive products for certain identified sexual health risk groups.

9.51 While the above benefits might be obtained through a VAT reduction for condoms only, that option is not recommended on the basis that there may be risks – however slight – associated with the different VAT treatment of different contraceptive products available by retail.

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REGULATORY IMPACT ASSESSMENT

Reduced Rate of VAT (5%) for Contraceptive Products

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 14 March 2006

Introduction

10.1 An amendment to the VAT Act to clarify that the power for HM Revenue and Customs officers to inspect goods for VAT purposes includes the power to mark the goods or their packaging and to record any information relating to the goods by electronic means.

Purpose and Intended Effect of Measure

The Policy Objective

10.2 To enable HM Revenue and Customs and others to identify and track the movement of goods suspected of being the subject of fraudulent supply chains, and enable HMRC, for the purpose of countering fraud, to identify goods that do not conform to the descriptions given to them by their suppliers.

10.3 The measure will apply to the whole of the UK.

Background

10.4 The measure is primarily aimed at combating a fraud often referred to as Missing Trader Intra Community or MTIC fraud. This is a systematic criminal attack on the VAT system, which is prevalent throughout the EU and constitutes the largest single source of fraudulent VAT losses for the UK Exchequer. Estimated annual losses from MTIC fraud for 2004/05 were between £1.12 and £1.9 billion.

10.5 The fraud is orchestrated by criminals who register a company for VAT in order to acquire goods VAT free from another EU Member State. They then sell the goods on, charging VAT to their customers but failing to pay it to HM Revenue and Customs. In these circumstances revenue losses arise when, later in the supply chain, the recipient of the supply is able to recover from HM Revenue and Customs the VAT charged to it by the defaulting supplier.

10.6 The fraud generally involves supplies of high value goods (typically mobile phones and computer processing chips) through contrived transaction chains. Its most abusive form, known as carousel fraud, involves the same goods circulating repeatedly between the UK and other EU Member States, often via third countries outside the EU, with VAT being stolen on each circuit.

10.7 This form of the fraud relies on the participation of a number of businesses to create a supply chain, the aim of which is to distance the missing or defaulting trader (who fails to pay to HM Revenue and Customs the VAT he has charged to his customers) from the trader who ultimately re-exports the goods and claims a VAT refund. These 'buffer' businesses may be controlled by the perpetrators of the fraud or may be drawn into the contrived supply chains, often as a result of failing to make pertinent enquiries about their suppliers.

10.8 The proposed measure would provide explicit authority for the 'stamping and scanning' of goods or their packaging by HM Revenue and Customs officers. This process normally entails applying an HM Revenue and Customs date stamp to the outer packaging (not the retail packaging) of goods and scanning any barcodes that appear on

the packaging to create an electronic record of any unique serial numbers applicable to the goods.

Rationale for Government Intervention

10.9 Tackling MTIC fraud is a high priority for the Government in light of continuing high revenue losses, as highlighted above. HM Revenue and Customs regard stamping and scanning as an important part of their strategy to combat the fraud, for the reasons explained below under options.

10.10 Attempts to carry out stamping and scanning under HM Revenue and Customs existing powers have been resisted by some of the businesses affected. While HM Revenue and Customs consider that the power is already implicit within the right to inspect goods under paragraph 10(2) of Schedule 11 to the VAT Act, these businesses have challenged the lack of an explicit reference in the VAT Act to any right to mark or stamp goods.

10.11 The uncertainty over the legal position causes problems for the freight forwarders who store these goods, as they face pressure from their customers not to allow the stamping to take place, but on the other hand face a risk of prosecution if they obstruct HM Revenue and Customs officers in the course of their duties. This has resulted in confusion and, in some cases, a risk of confrontational situations at freight forwarders' premises when HM Revenue and Customs have been refused access. The proposed intervention is therefore designed to provide legal certainty for all parties concerned.

Consultation

Within Government

10.12 The consultative committee for the HM Revenue and Customs Powers Review has been informed. There will be no impact on other parts of government.

Public Consultation

10.13 Although the proposed measures could be applied in any situation in which goods are stored for the purposes of taxable supplies, HM Revenue and Customs intention is to apply them only in the course of their operational activities to counter fraud. For the most part this will mean that the only businesses affected will be those that have traded in goods that have been involved in MTIC supply chains, and the freight forwarders who handle goods on their behalf.

10.14 In addition, HM Revenue and Customs has always considered that the power to stamp and scan goods is implicit within current legislation, and as such the current proposal merely represents a clarification of existing policy. We therefore consider that a wide public consultation is not appropriate.

10.15 Some businesses have expressed concern about the risk of damage or devaluation to goods from stamping. In response to this we have consulted major manufacturers of the goods concerned, who have confirmed that the application of an HM Revenue and Customs date stamp to the outer packaging of the goods would have no effect on their value.

Options

1. Do Nothing

10.16 Under this option, HM Revenue and Customs would rely on existing powers within the VAT Act to provide legal authority for stamping and scanning. These powers give HMRC the right to inspect goods, but do not specify precisely what actions are permitted in the course of an inspection.

10.17 This option would avoid any amendment to legislation. However, previous attempts to carry out stamping and scanning for MTIC purposes under existing powers have met with opposition from some of the businesses concerned, who have disputed HM Revenue and Customs legal authority and instructed their freight forwarders not to allow the stamping and scanning to take place. There is a strong likelihood that this would happen again and that officers could be obstructed in carrying out their duties.

10.18 Therefore, although HM Revenue and Customs have continued to carry out regular inspections of goods at the premises of these freight forwarders, they have refrained from stamping the goods.

10.19 Option 1 would entail HM Revenue and Customs invoking the sanctions that exist against the obstruction of officers, leading to arrests and prosecutions. This gives rise to a risk of confrontation, creating a risk to the health and safety of those involved. In addition, it is likely that the legal process to confirm the scope of the existing powers through the courts would cause a lengthy delay, which would frustrate HM Revenue and Customs ability to counter MTIC fraud.

2. Legislate to clarify the power of HM Revenue and Customs Officers to mark goods and take account of them by electronic means

10.20 This option would entail an amendment to the VAT Act to confirm that the power to inspect goods includes the power to mark the goods or their packaging, and to record any information relating to the goods by any means (including electronic means). This would allow HM Revenue and Customs proposed stamping and scanning activities to proceed with the benefit of legal certainty.

10.21 Stamping and scanning strengthens HM Revenue and Customs ability to challenge MTIC fraud in 3 ways:

- It helps to identify carousel movements of goods by showing up instances in which the same goods have been inspected more than once.
- It enables HM Revenue and Customs to check for false descriptions of goods. This is often a feature within MTIC fraud, as false descriptions can lead to the over-valuation of goods and a consequent increase in the amount of VAT that can be fraudulently extracted when the goods are supplied. Scanning enables barcode serial numbers to be checked against independent sources of information such as the GSMA register for mobile phones.
- It causes disruption and inconvenience to perpetrators of the fraud, who must either run the risk that the stamping and scanning will enable

fraudulent transaction chains to be detected or, to avoid this, re-package stamped goods or remove them from fraudulent supply chains.

10.22 There are, however, some risks associated with this option, which are examined under the heading costs below.

Costs and Benefits

Sectors and Groups Affected

10.23 The sectors affected will be those involving the trade in goods that are commonly subject to MTIC fraud. Currently the principal goods involved are mobile phones and computer chips. However, as explained under consultation above, HM Revenue and Customs only intends to apply the measure in the course of its operational activities to counter MTIC fraud. Therefore only a small number of businesses will be affected. In practical terms, the measure will impact most on the very small number of freight forwarders who store goods on behalf of businesses that have or may be trading in goods involved in MTIC supply chains.

10.24 To date HM Revenue and Customs has not considered it necessary to use stamping and scanning in situations other than those described above, and there are no plans to do so in the future. However, HM Revenue and Customs would not rule this out if stamping and scanning were found to be beneficial in tackling other areas of non-compliance within VAT.

Benefits

1. Do Nothing

10.25 There are no specific benefits to this option, other than avoiding the need for new legislation. It is possible that the benefits of stamping and scanning could be realised under this option, but only after the completion of the legal process arising from arrests and prosecutions for obstruction.

2. Legislation

10.26 Legislate to make HM Revenue and Customs power to stamp and scan explicit. This will enable HM Revenue and Customs to carry out its planned stamping and scanning activities, while minimising the scope for confrontation or lengthy legal disputes.

10.27 This will make a significant contribution to countering MTIC fraud, although the benefits are not directly quantifiable in revenue terms, since stamping and scanning is designed to support the application of a range of other measures to directly challenge revenue losses.

10.28 In addition, the presence of an HM Revenue and Customs date stamp will help legitimate businesses and the revenue authorities of other EU member states to identify goods that may be subject to carousel movements. This will help businesses to avoid becoming inadvertently drawn into fraudulent supply chains.

Costs

1. Do Nothing

10.29 Doing nothing would entail no direct costs to businesses since it would maintain the status quo. However, as explained above the legal uncertainty over the right to carry out stamping and scanning has caused problems for freight forwarders, and this may lead to increased indirect costs if the level of legal uncertainty escalates. On the one hand, freight forwarders face pressure from their customers not to allow stamping and scanning and on the other they run the risk of arrest and prosecution for obstruction if they seek to prevent HM Revenue and Customs officers from carrying out inspections.

10.30 In relation to Exchequer costs, this option would mean that the potential contribution of stamping and scanning to reduce revenue losses from MTIC fraud would not be fully realised, or at least there would be a significant delay in the realisation of those benefits until the matter is resolved through the courts.

2. Legislation

10.31 Legislate to make HM Revenue and Customs power to stamp and scan explicit. The freight forwarders principally affected by this measure are already subject to frequent visits by HM Revenue and Customs officers to inspect goods. Since the legislation simply clarifies existing powers, it will not of itself directly increase the number of inspections carried out by HM Revenue and Customs officers.

10.32 It simply allows a potential increase in operational activities through the provision of legal certainty. As such, no increased costs to businesses are directly attributable to this legislative change.

10.33 The proposed measure will enable HM Revenue and Customs officers to utilise their time more effectively when carrying out inspections. On the one hand, recording details by scanning is more efficient than recording the same information manually. However, stamping is an additional process, which is not normally performed at present, so this may mean that inspections take a little longer.

10.34 The overall effect of the measure on the volume of goods inspected cannot be estimated accurately at present for although scanning allows the record of inspection to be completed more quickly the scope for further inspections during a visit will be principally limited by the time taken to carry out the physical inspection. In some cases a net increase in the volume of goods inspected could lead to an increase in costs to businesses, due to the need to unpack and re-package more goods, where the goods need to be removed from pallets or from shrink-wrapping for the purposes of the inspection. However, as happens at present, HM Revenue and Customs will work with freight forwarders to minimise any costs arising from inspections including, where possible, timing inspections to coincide with businesses own inspections.

10.35 It has previously been alleged by some businesses that stamping can lead to damage or devaluation of goods, but no substantive evidence has been produced to support such claims. HM Revenue and Customs has consulted major manufacturers of mobile phones and computer chips, who have confirmed that the application of an HM Revenue and Customs date stamp to the outer packaging of goods should have no effect on their value. It is certainly true that an HM Revenue and Customs stamp would reduce the attractiveness of goods to those wishing to use them for MTIC fraud

purposes, because it increases the chance that the irregular movement of the goods will be detected. This is of course not a legitimate cost to be considered for the purpose of evaluating regulatory impact.

10.36 HM Revenue and Customs is also mindful of the right to free movement of goods in legitimate free circulation within the EU, and will take account of this within its procedures to ensure that the measure does not interfere with this right.

Small Firms Impact Test

10.37 As explained above, the practical impact of the proposed measure would not be significant, and on the basis of current plans would be limited to a very small number of businesses. Therefore the Government sees no reason why this proposal should have a disproportionate affect on small businesses.

Competition Assessment

10.38 This measure has passed the simple competition filter test, carried out in accordance with Cabinet Office guidelines. The Government is satisfied that the measure will have no impact on competition within legitimate markets.

Enforcement, Sanctions and Monitoring

10.39 Existing sanctions against the obstruction of HM Revenue and Customs officers (as laid down in the Commissioners for Revenue and Customs Act 2005) will be applied in the event of non-compliance with the proposed measure. HM Revenue and Customs will keep this under review and will consider bringing forward proposals for new sanctions if there is evidence of significant non-compliance.

Implementation and Delivery Plan

10.40 The change will be publicised through a Budget Note (available on the HM Revenue and Customs internet site) and a reference in VAT Notes, which is sent to all VAT registered businesses with their VAT returns.

10.41 The extent and timing of stamping and scanning exercises following the introduction of the new measure will be determined by HM Revenue and Customs on the basis of risk assessment and the availability of resources.

Post Implementation Review

10.42 An assessment of the implementation of the measure will be carried out 18 months after the implementation date to review its effectiveness. This will include a review of the current assessments of minimal impact and cost to businesses, taking into consideration any complaints or concerns expressed by businesses affected by the measure.

Summary and Recommendation

10.43 Stamping and scanning is an effective and proportionate measure, which can play an important role in countering the serious revenue losses arising from MTIC fraud. Since the current legal uncertainty clearly hampers HM Revenue and Customs ability to carry out this activity, we recommend that Option 2: legislation to make HM Revenue and Customs power to stamp and scan explicit, be adopted.

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REGULATORY IMPACT ASSESSMENT

VAT: Clarification of HMRC Powers to Inspect Goods

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 15 March 2006

REGULATORY IMPACT ASSESSMENT FOR VAT: POWER FOR HMRC TO DIRECT INDIVIDUAL BUSINESSES

Introduction

11.1 A proposal to give HM Revenue and Customs the power to direct individual businesses to keep specified additional records in relation to goods.

Purpose and Intended Effect of Measure

The Policy Objectives

11.2 To enable HM Revenue and Customs to identify goods suspected of being the subject of fraudulent supply chains.

11.3 To enable HM Revenue and Customs, for the purpose of countering fraud, to identify goods that do not conform to the descriptions given to them by their suppliers.

11.4 The measure will apply to the whole of the UK.

Background

11.5 The measure is primarily aimed at combating a fraud often referred to as Missing Trader Intra Community or MTIC fraud. This is a systematic criminal attack on the VAT system, which is prevalent throughout the EU and constitutes the largest single source of fraudulent VAT losses for the UK Exchequer. Estimated annual losses from MTIC fraud for 2004/05 were between £1.12 and £1.9 billion.

11.6 The fraud is orchestrated by criminals who register a company for VAT in order to acquire goods VAT free from another EU Member State. They then sell the goods on, charging VAT to their customers but failing to pay it to HM Revenue and Customs. In these circumstances revenue losses arise when, later in the supply chain, the recipient of the supply is able to recover from HM Revenue and Customs the VAT charged to it by the defaulting supplier.

11.7 The fraud generally involves supplies of high value goods (typically mobile phones and computer processing chips) through contrived transaction chains. Its most abusive form, known as carousel fraud, involves the same goods circulating repeatedly between the UK and other EU Member States, often via third countries outside the EU, with VAT being stolen on each circuit.

11.8 This form of the fraud relies on the participation of a number of businesses to create a supply chain, the aim of which is to distance the missing or defaulting trader (who fails to pay to HM Revenue and Customs the VAT he has charged to his customers) from the trader who ultimately re-exports the goods and claims a VAT refund. These 'buffer' businesses are either controlled by the perpetrators of the fraud or are drawn into the contrived supply chains, often as a result of failing to make pertinent enquiries about their suppliers.

11.9 The proposed measure would allow HM Revenue and Customs to issue notices directing individual businesses to keep records of information such as unique serial

numbers for goods that they trade in. The most common example is likely to be IMEI numbers¹ for mobile phones.

Rationale for Government Intervention

11.10 Tackling MTIC fraud is a high priority for the Government in light of continuing high revenue losses, as highlighted above. HM Revenue and Customs regard this measure as an important part of their strategy to combat the fraud, for the reasons explained below under options.

Consultation

Within Government

11.11 The consultative committee for the HM Revenue and Customs Powers Review has been informed. There will be no impact on other parts of government.

Public Consultation

11.12 HM Revenue and Customs does not propose to carry out a public consultation exercise for this proposal. The measure will only affect a relatively small number of businesses, and the issue of record-keeping directions will be conditional on HM Revenue and Customs having reasonable grounds to believe that the records might assist in identifying instances of MTIC fraud.

11.13 HM Revenue and Customs enquiries have indicated that the records that businesses will be required to keep under this measure will in most cases consist of information that is commonly recorded anyway for commercial purposes. For example, dealers in mobile phones will, for warranty purposes, commonly keep records of IMEI numbers for phones they have bought and sold.

Options

1. Do Nothing

11.14 This would preserve the status quo, and would of course entail no additional costs for businesses. However, this option would restrict HM Revenue and Customs ability to counter MTIC fraud through the identification of carousel movements and false descriptions of goods.

2. Implement new record-keeping requirements using HM Revenue and Customs existing powers

11.15 The law currently allows HM Revenue and Customs to publish a notice to require all businesses of a particular description to keep specific records for VAT purposes. HM Revenue and Customs could therefore achieve its policy objectives by publishing notices aimed at business sectors in which MTIC fraud is prevalent (the most prevalent sectors currently being those involving the supply of mobile phones and computer components). However, this would impact on a far greater number of businesses than would be the case under Option 3.

¹ International Mobile Equipment Identification numbers

3. Legislate to introduce a new power for HM Revenue and Customs to direct individual businesses to keep specified records

11.16 This option would entail an amendment to the VAT Act to introduce the proposed new power allowing HM Revenue and Customs to direct individual businesses. This would enable the policy objectives to be achieved, whilst minimising the number of businesses affected.

11.17 The keeping of records that identify the particular goods that a business has traded will strengthen HM Revenue and Customs ability to challenge MTIC fraud by:

- Helping to identify carousel movements of goods by identifying instances in which the same goods have been recorded more than once. This will be done by carrying out checks against the details of goods that HM Revenue and Customs have previously scanned in the course of their inspections.
- Enabling HM Revenue and Customs to check for false descriptions of goods, which is often a feature within MTIC fraud, as false descriptions can lead to the over-valuation of goods and a consequent increase in the amount of VAT that can be fraudulently extracted when the goods are supplied. For example, IMEI numbers for mobile phones can be checked against independent sources of information.

11.18 In addition, HM Revenue and Customs regards the keeping of such records as prudent commercial practice for businesses trading in an environment in which MTIC fraud is prevalent. Maintaining and checking records of serial numbers can help such businesses to avoid becoming inadvertently involved in carousel transaction chains.

11.19 It may also assist them to demonstrate that they have exercised due diligence, which is a relevant factor for HM Revenue and Customs when considering the application of other measures for countering MTIC fraud, such as joint and several liability for debts arising from the default of another business within the same supply chain.

11.20 By enabling HM Revenue and Customs to target record keeping requirements at businesses operating in areas of greatest risk, this option would be a far more proportionate approach to the problem of MTIC fraud, in comparison with Option 2. At present, the majority of MTIC fraud involves trading in mobile phones and computer chips, but is not confined to such goods. Option 3 enables HM Revenue and Customs to target record keeping requirements on the basis of risk and to respond to variations in the fraud, without having to impose requirements across the board on all businesses within a particular sector.

Costs and Benefits

Sectors and Groups Affected

11.21 Under Option C, the measure would not be targeted at specific business sectors. As explained above, the proposal allows HM Revenue and Customs to issue directions only where they have reasonable grounds to believe that the records might assist in identifying instances of fraud. In the short term the majority of businesses affected will be ones trading in mobile phones and computer chips, since these are currently the

principal goods used to perpetrate MTIC fraud. It is estimated that the measure will initially affect around 1,000 businesses.

Benefits

1. Do Nothing

11.22 There are no specific benefits to this option.

2. Implementation

11.23 Implement new record-keeping requirements using HM Revenue and Customs existing powers. This would enable HM Revenue and Customs to achieve its initial policy objectives and would avoid the need for new legislation.

3. Legislation

11.24 Legislate to introduce a new power for HM Revenue and Customs to direct individual businesses to keep specified records. This would achieve the stated policy objectives whilst minimising the impact on businesses.

11.25 The measure will make a significant contribution to countering MTIC fraud, although the benefits are not directly quantifiable in revenue terms, since the records will be a source of intelligence and evidence to support the application of a range of other measures to directly challenge revenue loss from the fraud.

Costs

1. Do Nothing

11.26 This option would entail no additional costs for businesses. However, HM Revenue and Customs regard the proposed measure as an important tool to support its operational activities to target MTIC fraud. The 'do nothing' option would compromise HM Revenue and Customs ability to tackle the fraud and would mean that the contribution of the proposed measure to reducing revenue losses from MTIC fraud would not be realised.

2. Implementation

11.27 Implement new record-keeping requirements using HM Revenue and Customs existing powers. This option would impact on a far larger number of businesses than would be the case for Option 3. This is because the record-keeping requirements would apply to all businesses of a particular description. Initially, this would be limited to the business sectors in which MTIC fraud is currently prevalent (particularly the supply of mobile phones and computer chips).

11.28 However, the fraud is not confined to these sectors and could mutate to other goods, which would mean that further notices covering other business sectors would have to be published in order to continue to meet the policy objectives. It is estimated that this measure would affect up to 15,000 businesses. While it is likely that many of the businesses concerned would already keep the records for commercial purposes, the remainder would incur additional costs.

3. Legislation

11.29 Legislate to introduce a new power for HM Revenue and Customs to direct individual businesses to keep specified records. Under this option, only those businesses operating in areas of MTIC fraud risk would be required to keep additional records. These businesses would incur additional administrative costs, which we would estimate to be, on average, around £1,000 per affected business for the first year of operating record-keeping requirements under this measure. However, as explained above, there would be a benefit to businesses in helping them to identify goods potentially linked to MTIC fraud.

Small Firms Impact Test

11.30 The businesses affected by the measure will largely fall into the category of small businesses in relation to the number of staff that they employ, although many have a turnover that would bring them into the large business category. However, the measure has been designed so that its impact will be limited to a relatively small number of businesses trading in an environment in which there is a risk of involvement in MTIC transaction chains. In these circumstances, the Government's view is that requiring businesses to keep these records is a reasonable and proportionate response to the serious revenue loss from MTIC fraud.

Competition Assessment

11.31 This measure has passed the simple competition filter test, carried out in accordance with Cabinet Office guidelines. The Government is satisfied that the measure will have no impact on competition within legitimate markets.

Enforcement, Sanctions and Monitoring

11.32 The proposed measure includes a new sanction to encourage compliance. This consists of a penalty of £200 for each day on which a business fails to comply with the requirements stated in a direction, up to a maximum of 30 days. This 30 day period will begin on the date from which the direction takes effect, which will be a future date, to be specified in the notice of direction.

11.33 The level of penalty reflects the significant sums of money at stake from MTIC fraud, in relation to which the existing penalty for breaches of VAT record-keeping requirements (£5 per day for up to 100 days) would not provide an adequate deterrent to non-compliance. The consequences of non-compliance would be clearly spelt out in the notice of direction, and the proposal includes a right of appeal against any penalty imposed, in addition to a right of appeal against the issue of the directions themselves.

Implementation and Delivery Plan

11.34 HM Revenue and Customs will publish full guidance on the measure nearer to its date of implementation. Directions will be issued by notice in writing to the businesses concerned, and will specify the types of goods covered by the requirement, the information to be recorded, the effective date, and details of the penalties for non-compliance and rights of appeal.

Post-implementation Review

11.35 An assessment of the implementation of the measure will be carried out 18 months after the implementation date to review its effectiveness. This will include a review of the impact and cost to businesses.

Summary and Recommendation

11.36 We recommend Option 3, i.e. legislate to introduce a new power for HM Revenue and Customs to direct individual businesses to keep specified records, because it will enable HM Revenue and Customs to realise its policy objectives of helping to combat fraud, while minimising the impact of the measure on businesses.

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REGULATORY IMPACT ASSESSMENT

VAT: Power for HMRC to Direct Individual Businesses to Keep Additional Records

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 15 March 2006

RIA FOR VAT: CARS (AMENDMENT) AND VAT: SPECIAL PROVISIONS (AMENDMENT) (2) ORDERS 2006

Introduction

12.1 The Value Added Tax (Cars) (Amendment) Order 2006 and The Value Added Tax (Special Provisions) (Amendment) (No.2) Order 2006

Purpose and Intended Effect of Measure

The Policy Objective

12.2 The amendments close a loophole in the VAT treatment of goods sold, for the second time, by a finance company.

Background

12.3 The loophole arises where the sale of goods is made under finance agreements such as hire purchase and conditional sale agreements. These allow the cost of the goods to be spread over an extended period.

12.4 For VAT purposes, provided the finance charges are clearly identified to the customer, such sales are treated as two supplies (by the finance company) - the supply of goods at the 'cash' price (which is subject to VAT) and a separate supply of finance (which is exempt from VAT). The finance company is required to account for the full amount of VAT at the time the goods are removed or delivered, as if all the payments required under the agreement had been received. However, legal ownership of the goods remains with the finance company until the customer has actually made all the payments.

12.5 The problem arises when the customer fails to make all the payments required under the agreement. This can arise in one of two ways:

- The customer exits the agreement early - either under statutory rights or under the particular terms of the agreement. In these circumstances the customer is required to return the goods to the finance company who will then sell the goods for a second time.
- The customer defaults on the agreement - e.g. by not keeping up the payments due. In these circumstances the finance company will repossess the goods and sell them in an attempt to make good their loss

12.6 Transactions affected by this proposal occur mainly in respect of finance agreements for goods (primarily cars) bought by households or by others unable to recover the VAT incurred on their purchase.

12.7 The High Court in *General Motors Acceptance Corporation (GMAC)*¹ found that, in either circumstance, the finance company could obtain relief on both the first and the second sale. As a result of this judgement an element of consumption via finance agreements goes untaxed. Based on claims received following the litigation, this is estimated to result in revenue losses of around £20 million. The current situation presents a significant a risk of further revenue losses through new avoidance activity

¹ Case reference CH/2003/APP/0230

exploiting the loophole and also leaves the UK open to infraction proceedings by the Commission.

Consultation

12.8 Informal discussions have been held with the two main trade associations – the Finance and Leasing Association (FLA) and the British Vehicle Rental and Leasing Association (BVRLA). Whilst accepting the reasons for the changes the associations have expressed concern that changes will increase compliance costs for their members. These compliance costs are expected to relate mainly to one-off system changes required to identify the VAT treatment of goods (mainly vehicles) from the outset of finance agreements.

Options

1. Do Nothing

12.9 This option effectively maintains the current situation following the legal judgement that allows a finance company to obtain relief on both the first and the second sale of the same goods.

2. Remove relief on the second sale

12.10 This option proposes to change the VAT (Cars) Order 1992 and VAT (Special Provisions) Order 1995, removing the relief on the second sale by making it taxable.

3. Industry proposal

12.11 Industry representatives suggested an alternative approach. This option allows the finance company to limit its own claim for relief on the first sale and in turn retain relief on the second sale.

Costs and Benefits

Sectors and Groups Affected

12.12 The trade associations we discussed the proposals with account for the vast bulk of the sector, made up of less than 50 companies, supplying goods under finance agreements.

Benefits

1. Do Nothing

12.13 The benefits of a do nothing option are that no legislative changes would be required and there would be no compliance cost implications for businesses. However, this option does not address the risks from avoidance exploiting the loophole or infraction proceedings by the Commission.

2. Remove relief on the second sale

12.14 This option ensures that each transaction made under finance agreements would bear an appropriate VAT charge and also prevents the use of the loophole for tax avoidance purposes. In addition it ends annual revenue losses of some £20 million.

12.15 However, this option does result in compliance costs for businesses although a lead-in period provides businesses with an opportunity to adapt their systems prior to the change having full effect.

3. Industry proposal

12.16 In common with option 2, this option ensures that sales made under finance agreements would bear an appropriate VAT charge, prevents the use of the loophole for tax avoidance purposes and ends annual revenue losses of some £20 million.

12.17 It would have an optimal benefit in terms of compliance cost implications for businesses in having the advantage of avoiding the need to make any system changes.

12.18 However, legal advice has indicated that this option is not available as it would be directly counter to the Sixth VAT Directive 77/388. As such, this option would not ensure that UK law will apply the Sixth VAT Directive correctly, would be open to challenge by UK businesses and risk of Commission infraction proceedings would remain.

Costs

1. Do Nothing

12.19 A do nothing option would not address the fact that the UK's current regulations do not result in the correct level of VAT being collected on goods sold under finance agreements. Continued failure to correct the situation would give businesses in this sector an unjustified advantage over other businesses and leave the UK open to infraction proceedings by the Commission. This option also gives a significant risk from introduction of avoidance schemes to exploit the loophole, which would result in revenue losses to the Exchequer and distortion between those business that adopt schemes and those that do not.

12.20 This option would have no compliance cost implications for businesses.

2. Remove relief on the second sale

12.21 This option would result in the correct level of VAT being collected on goods sold under finance agreements. We do not believe that the measure would be liable to successful challenge by UK business as it brings UK law more closely into line with EU law.

12.22 The principal costs that businesses have identified relate to one-off system changes to capture information at the start of a finance agreement, which is not currently captured or is not contained within the systems that deal with the returned goods. The cost of making these system changes will vary between different businesses and will depend largely on the complexity and flexibility of existing systems. Indicative estimates for a sample of businesses received through industry representatives range from £100,000 to £500,000. It is expected that particularly large businesses with international systems will experience the most significant costs. Other costs identified

include staff training and compliance checking. Ongoing compliance cost implications are not expected to be significant once the initial system changes are established.

12.23 Three approaches to implementation have been considered:

- 1. Introducing with immediate effect for all existing and new agreements:** This requires the system changes needed to capture relevant information at the start of agreements, training and implementation of compliance checks. However, while the system changes are being developed businesses would also need to set up and operate a temporary manual system for collecting information on existing and new agreements entered into until the permanent system changes are implemented and then transfer all the information onto the permanent system. The industry have estimated costs of around £10 million for introduction on this basis.
- 2. Introducing with immediate effect for new agreements only:** Compliance costs for the industry in introducing on this basis are estimated to be reduced to £7.5 million, with businesses no longer required to collect, record or transfer information about existing agreements.
- 3. Introducing for new agreements where the goods are delivered on or after 1 September 2006:** By introducing for new agreements, where the goods are delivered on or after 1 September 2006, it is estimated that compliance costs would be reduced further to £5 million for the industry. The reduction in set up costs is realised by avoiding the need for a temporary manual system completely.

3. Industry proposal

12.24 Legal advice has indicated that this pragmatic option, allowing a finance company to limit its own claim for relief on the first sale and retain relief on the second sale, would be directly counter to the Sixth VAT Directive 77/388. There is a risk of successful challenge by UK business or of Commission infraction proceedings.

12.25 This option would have no compliance cost implications for businesses, as it would avoid the need to make any system changes.

Small Firms Impact Test

12.26 Small businesses are not expected to be affected by changes proposed in any of the options, as finance companies are generally larger businesses. This has been confirmed in discussions with industry representatives.

Competition Assessment

12.27 A competition filter has been completed. We consider that that there will not be a negative competition assessment for the following reasons:

- The three largest firms in the market affected by the amended regulations do not have at least 50% market share
- The amended regulations are not likely to affect the market structure, changing the number or size of firms
- The amended regulations will not lead to higher set up costs for new or potential firms that existing firms do not have to meet

- The amended regulations will not lead to higher ongoing costs for new or potential firms that existing firms do not have to meet
- The market is not characterised by rapid technological change
- The amended regulations will not restrict the ability of firms to choose the price, quality, range or location of their products

Enforcement, Monitoring and Sanctions

12.28 HM Revenue and Customs staff as part of the assurance of the businesses affected will monitor compliance with the regulations. Those businesses will be subject to the usual enforcement procedures for VAT registered businesses. No additional cost for HMRC is envisaged as a result of this.

Implementation and Delivery Plan

12.29 Updated guidance on the effect of the measure will be produced in the form of a VAT Information Sheet on the day of the announcement of the measure and VAT Notice 701/49 Finance and Securities will be revised when next updated.

Post-implementation Plan

12.30 We will carry out a post-implementation review as soon as the change has bedded in and suitable data are available. We expect that to be within 3 years of implementation, but will monitor developments to ensure that any review is neither premature, nor unnecessarily delayed. The findings will be used to enhance the policy-making process – both in this area and across HMRC in general.

Summary and Recommendation

12.31 The measure is intended to close a loophole in the current UK VAT law.

12.32 The options we have are:

- do nothing; this would leave the UK open to infraction proceedings by the Commission, would allow businesses escape a VAT charge on some of the supplies they make, and would risk wider exploitation of the loophole;
- industry proposal; this would leave the UK open to challenge by UK businesses and infraction proceedings by the Commission; or
- introduce the above which amendment to the regulations; the Department's view is that the amendment represents the only legally sound means of preventing loss of revenue through the exploitation of the loophole.

12.33 It is therefore recommended that the changes outlined in Option 2(3) are adopted.

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REGULATORY IMPACT ASSESSMENT

The Value Added Tax (Cars) (Amendment) Order 2006 and The Value Added Tax (Special Provisions) (Amendment) (No 2) Order 2006

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 1 March 2006

Introduction

13.1 This is a full Regulatory Impact Assessment on the implementation of the simplification of the taxation of pensions. It updates and expands on the Regulatory Impact Assessment “Simplifying the taxation of pensions” published on 8 April 2004 and the appendix to that Regulatory Impact Assessment published on 16 March 2005 to reflect the changes enacted in Finance Act 2005 and subsequent regulations, and those to be enacted in Finance Bill 2006.

Purpose and Intended Effect of Measure

The Policy Objectives

13.2 The Government wants to encourage today’s workers, tomorrow’s pensioners, to save for their retirement and offers generous tax incentives to encourage people to invest in a pension. The key objectives of this reform, taking effect from 6 April 2006 - “A day” - are to modernise and simplify the tax rules for pensions, increasing individual choice and flexibility and cut industry costs by tackling the complexity and fragmentation caused by the current rules. There will be a single coherent set of rules applying to all kinds of tax privileged pension schemes leading to:

- improved choice and flexibility for pension providers, employers and individuals saving in pensions;
- improved competition among financial services firms providing pensions;
- greater encouragement for individuals to save for retirement; and
- reduced administration and compliance costs for sponsoring employers, pension scheme administrators, providers and advisers.

13.3 At the same time all existing pension rights under the old rules will be protected.

Rationale for Government Intervention

13.4 The complexity of the current tax rules, compounded by the different regimes coexisting, increases administration costs for the pensions industry. It also acts as a barrier to entry to financial service providers wishing to provide pension services and products, to employers sponsoring pension schemes and to individuals investing in pensions. Radically simplifying the rules will help remove these barriers and reduce these costs.

13.5 In order to address this problem, in March 2001 the Government launched a review by the then Inland Revenue, working with informed help from the pensions industry to look at a wide range of pensions issues. This culminated in the publication of the December 2002 consultation document “Simplifying the taxation of pensions: increasing choice and flexibility for all” which set out proposals for the radical simplification of pensions taxation.

13.6 This was followed in December 2003 by a second consultation paper “Simplifying the taxation of pensions: the Government’s proposals” which reflected the

views drawn from responses to the earlier consultation and set out detailed proposals for the new pension taxation regime.

13.7 The main part of the new legislation is contained in Finance Act 2004, with additional legislative changes in Finance Act 2005. Details of further changes were announced at the 2005 Pre Budget Report. Draft regulations for consultation have been published on HM Revenue and Customs website in an ongoing programme since August 2004 and finalised regulations have been laid in time for the commencement of the new regime on 6 April 2006.

Options

13.8 The two options considered by the Government in the December 2003 document, were to do nothing, leaving the various current tax regimes in place (see Annex A), or radical simplification of the pensions regimes across the board.

13.9 To do nothing would have protected the future expectations of a small number of high earners in uncapped pre-1989 pension schemes who would be disadvantaged by the new regime. Then, in 30 or so years time, when all the remaining pre-1989 members will have retired, the single then remaining occupational regime and the single personal pension regime could be brought together.

13.10 But the Government is convinced of the need to act now to remove the barriers and constraints that the current pension rules place on everyone involved in pensions i.e. employers, individuals, pension providers and advisers.

13.11 The responses to the December 2003 proposals overwhelmingly urged the Government to bring in the new regime, and to end the existing regimes. Consequently, the new regime for pension tax simplification will begin on 6 April 2006 – known as ‘A Day’.

New Measures

13.12 The Finance Act 2004 introduced a single unified set of tax rules for all pensions qualifying for tax relief. Most of the tax restrictions on contributions, fund build-up, and benefits will be scrapped. The main proposals for the new regime, which will start on 6 April 2006, are summarised below.

- The current plethora of limits on contributions, scheme build-up and emerging benefits (see summary at Annex A) will be replaced by two allowances:
4. A single, lifetime allowance for the amount of pension savings that can benefit from tax relief, of £1.5 million at 2006/07, rising in stages to £1.8 million by April 2010¹, and reviewed quinquennially thereafter;
 5. An annual allowance for the amount of tax relieved contributions and/or increased benefits, of £215,000 in 2006/07, rising in stages to £255,000 by April 2010², and reviewed quinquennially thereafter. Tax relief on individuals’ contributions will be given on the higher of £3,600, or 100% of UK chargeable earnings.

¹ Rising from £1.5 million for 2006/07 to £1.6m for 2007/08, £1.65m for 2008/09, £1.7m for 2009/10 to £1.8m for 2010/11.

² Rising from £215,000 for 2006/07 to £225,000 for 2007/08, £235,000 for 2008/09 to £245,000 for 2009/10 to £255,000 for 2010/11.

13.13 In practical terms this will mean that most people can make pension contributions with tax relief, up to whatever they can afford, without being bound by the contribution and/or benefit limits of the current tax regimes. Instead, anyone who builds up total pension rights worth more than the lifetime allowance of £1.5 million will bear a lifetime allowance charge of 25%³ on any benefits taken in excess of the lifetime allowance.

- Employers will now be able to make unlimited contributions (subject to the tax free allowances mentioned above) to a registered pension scheme on behalf of an employee or former employee without having to check the benefits building up against any HMRC limits. Except in very limited circumstances, where they are not made “wholly and exclusively” for the purposes of the business, contributions paid will qualify as a tax deduction for the employer. As now, relief on certain exceptionally large contributions will be spread over a period of up to four years.
- Minimum pension age will be increased from 50 to 55 from 6 April 2010, or at an earlier date if schemes so choose. But there will be protection for certain people who have pre-existing rights to draw benefits from age 50, or to a low normal retirement age. Pension savings must, as now, be converted into a guaranteed income stream by age 75.
- Members of occupational schemes will, from minimum pension age, be able to start receiving a pension without having to retire from that employment. This option is currently only available to members of personal pension schemes and is generally referred to as “flexible retirement”.
- New schemes will no longer need to seek formal approval from HMRC. There will be a registration process, which will be available electronically from April 2006 and it will no longer be necessary to submit scheme rules and amendments to HMRC for approval. Existing approved schemes will automatically be registered from A day, unless the scheme opts out and becomes an unregistered scheme (to be known as “employer-financed retirement benefits schemes”).
- The proposals originally allowed for a single set of investment rules for all pension schemes, allowing all schemes to invest in assets, such as residential property or works of art. However, following concerns that a number of people were planning to use tax relief given for contributions to self-directed pension schemes for the purpose of funding purchases of holiday or second homes and other assets primarily for personal use rather than as an investment for generating an income in retirement, SIPPs and all self-directed schemes will be prohibited from investing in assets from which the members may derive a benefit.
- There will be a single set of benefit rules for the new regime that will cover all tax-privileged schemes. There will also be a single rule for the amount of benefit that can be taken as a tax-free lump sum: up to 25% of the capital value of the total benefits, up to an overall limit of 25% of the lifetime allowance (so £375,000 for 2006/07 viz. 25% x £1.5 million).

³ The lifetime allowance charge will be levied at 55% if the benefits are taken in lump sum form.

- Schemes that are currently funded, or unfunded, unapproved retirement benefits schemes (known as FURBS and UURBS) will be allowed to continue outside the new tax-privileged regime, as employer-financed retirement benefits schemes, subject to transitional arrangements. There will be changes to the taxation rules for employers' contributions, on the benefits paid and to the taxation of investment income of employer-financed retirement benefits pension schemes set up by way of a trust.

Changes enacted in Finance Act 2005

13.14 As a consequence of ongoing consultation, additional legislative changes were enacted in Finance Act 2005. These measures were intended to allow increased flexibility in scheme design, augment transitional rules to protect existing rights and also included some anti-avoidance measures to counteract potential abuse. The full package of measures was set out in HMRC Technical Note of 16 February 2005. A link to this document can be found at the end of this Regulatory Impact Assessment.

Changes to be enacted in FB 2006

Residential Property and Other Assets **13.15** The Government will tighten the rules governing allowable investment by all registered pension arrangements where the scheme member can direct which investments the scheme makes. This change was announced in the Pre Budget Report of 5 December 2005.

Recycling of Tax-Free Lump Sums **13.16** The Government is also taking action to stop the potential abuse of the tax simplification rules by means of a device designed to boost the amount in a pension scheme through the artificial generation of tax reliefs. Under the new pensions tax rules, individuals would have been able to take tax-free lump sums from their pension schemes, recycle these back into their pension fund with further tax relief on them, potentially boosting their pension fund without having to pay in any new money.

13.17 This type of abuse, which is intended to do nothing more than generate artificially high amounts of tax relief through a circulation of money, will be prevented. This change was also announced at PBR. The draft legislation and accompanying guidance was published for consultation on 3 February 2006.

Further Measures **13.18** A small package of pensions simplification measures, building on those in Finance Act 2004, is being introduced. Details of these measures are included in the Technical Note published on 5 December 2005, listed in Annex B of this RIA and linked to at the end of this RIA and a further announcement made on 7 March 2006

- A rule to amend the calculation of pension commencement lump sums paid in respect of money purchase arrangements, so that where a scheme pension is provided from a money purchase arrangement the lump sum will be calculated as 25% of the funds used to provide the benefits. This change responds to industry concerns that the basis of calculation for these lump sums would increase advice costs for schemes and their members.
- A rule to amend the scheme pension rules to make it easier for schemes to provide additional pension up to the member reaching state pension age.

13.19 Other measures are designed to ease some of the requirements of the new rules, allowing greater access to tax relief on their pension savings, such as:

- Extending the circumstances in which migrant workers can claim relief on contributions to overseas pension schemes, so that they may still claim relief following a block transfer of their pension rights
- Extending the transitional protection from the Lifetime Allowance tax charge to include certain pre A-Day entitlements to lump sum death benefits, payable where an individual dies before age 75. This will ensure that members can continue to make regular premiums to term assurance life policies without losing the benefits of their transitional protection.
- There are also some minor rules that clarify the Finance Act 2004 legislation.

Inheritance tax 13.20 Following consultation by HMRC, the Government announced at PBR 2005 that legislation in 2006 Finance Bill would clarify how IHT is to be applied to pension choices under registered pension schemes. The rules for scheme members under age 75 will work largely as they do pre A-day. Where a member over age 75 dies with an alternatively secured pension (ASP), subject to an exemption for payments to charity and qualification where financial dependants are involved, IHT will be charged on the scheme administrator on the leftover funds at death by reference to the deceased's estate. This will impact on schemes mainly where there is an IHT charge.

13.21 The IHT liability and accountability, like other charges on the fund, will fall on the scheme administrator. Schemes will already have regulatory obligations in relation to ASPs; IHT considerations will be additional to those. Subject to enabling provisions in the Finance Bill, HMRC IHT reporting and accounting requirements are sufficiently flexible to cover this new aspect subject to updating the relevant forms and guidance. HMRC will work closely with the Industry to ensure that suitable procedures are put in place to minimise the regulatory impact.

Sectors and Groups Affected

Current members 13.22 10 million individuals are currently accruing rights in an occupational scheme, with around 5 million making some contribution, individual, or employer or both, to a personal or stakeholder pension. In addition around half a million are still contributing to retirement annuity contracts, the forerunners of personal pensions. Over three-quarters of these are already in either the post-1989 occupational pension regime, or in personal pension schemes, both limited by reference to the statutory earnings cap, which the new lifetime allowance broadly mirrors⁴.

Current schemes 13.23 There are currently just under 100,000 Occupational Pension schemes with two or more members, with the vast majority of members concentrated in very few schemes – around three quarters in the 300 or so largest schemes. Table 13.1 below shows the distribution of members across existing pension schemes. In addition there are around 250 financial institution providers of personal and stakeholder pensions.

13.24 Self-administered schemes have around £800 billion of assets under management, with insurance administered and personal pension schemes having another £600 billion⁵

⁴ The new lifetime allowance of £1.5 million is broadly based on the statutory earnings cap, introduced in 1989 for both occupational and personal pensions. Since then the maximum pension that can be earned in an occupational pension scheme is two thirds of final salary, subject to the earnings cap of (for 2004/2005) £102,000, i.e. £68,000. The lifetime allowance is set at a level that broadly replicates the maximum that an individual can accrue over a working lifetime under the current occupational pension rules.

⁵ Survey of Self-Administered Pension Funds, MQ5, ONS. Assumed 60% of insurance companies long-term funds cover pensions business.

Table 13.1 Self-administered Schemes

Size of Scheme (Members)	Number of Active Members Accruing Benefits (Millions)
10,000 or more	7.4
5,000 - 9,999	0.6
1,000 - 4,999	0.9
100 - 999	0.7
12 - 99	0.1
2 - 11	0.2
Total	9.8

Source: *Occupational Pension Schemes 2004 - Twelfth survey by the Government Actuary, Government Actuary's Department.*

Costs and Benefits

Benefits

13.25 The benefits of the reform will be felt by everybody involved in pension savings and provision.

The Pensions Industry (sponsoring employers, scheme administrators, providers and advisers)

13.26 Although it is difficult to quantify the benefits precisely, a 2001 survey of key players in the pension industry conducted by HM Revenue and Customs⁶ suggested that the new steady state administrative cost savings to the pensions industry could be of the order of 5 per cent, about £80 million a year. Subsequently, responses received to the December 2002 consultation and the detailed proposals published in December 2003 have confirmed the difficulties of estimating cost savings in the absence of more detailed information.

13.27 Thus, the Government's best estimate remains as above. However, work currently underway due to report in the summer should allow HMRC to update this estimate in due course.

Employers

13.28 The new rules will permit flexible retirement, helping employers retain experienced staff and allowing staff to stay on longer in work. (Current rules prevent occupational scheme members from drawing a pension without leaving that employer's service, whereas individuals with personal pensions may, if they wish, commence drawing their pension as soon as they reach minimum pension age).

13.29 those employers that have previously been deterred from setting-up schemes, because of the overall cost and complexity, may now decide to do so.

Members of Occupational Pension Schemes

13.30 Should, like members of personal pensions currently, have more opportunities to use their pension rights flexibly, to mix work and retirement toward the close of their careers.

⁶ Survey of pensions industry by HM Revenue and Customs, in conjunction with the Association of British Insurers and the National Association of Pension Funds, November 2001.

Pension Scheme Savers **13.31** Will nearly all be able to save more with tax relief if they wish. They will have increased flexibility in the amount they can save and when they can save, and the potential of a more generous tax-free lump sum. The exception to this will be a small number of high earners not subject to the 1989 earnings cap, whose future tax privileged pension saving will be capped by the lifetime allowance.

13.32 In the 2002 consultation document, the Government estimated that fewer than 5000 individuals currently in pre-1989 uncapped regimes would be affected by the lifetime allowance on its introduction. This estimate was arrived at using a number of data sources including those on contribution rates, accrual rates and length of service. Looking further forward, it was estimated that the lifetime allowance would perhaps affect another 1000 individuals a year, who were previously in pre-1989 schemes, over the next ten years.

13.33 In December 2003 the Government asked the National Audit Office (NAO) to look at these figures to consider whether they were reliable estimates. The NAO reported in March 2004 and concluded that the Government's estimates were reasonable, although the figure of 5000 was at the lower end of a range of reasonable estimates. They suggested that the sensitivity testing and other evidence was consistent with an estimate of around 10,000. They also said that the evidential base for the 1000 per year going forward was thin, but that evidence from a survey of major companies, current pensions in payment data and other evidence, did not discredit HMRC estimate. A link to the full text of the report may be found at the end of this document.

People not yet saving for a Pension **13.34** Will find it easier to get started as they will need less advice and face lower costs. In turn this should mean that they are unencumbered in achieving an appropriate level of pension saving for retirement.

Independent Financial Advisers **13.35** Will need less detailed knowledge of different tax regimes, reducing their training costs. In response to the December 2002 consultation one industry representative suggested savings in training costs for this group alone could amount to £10 million per year

13.36 More generally, the new regime will allow for much greater flexibility over scheme design. This will mean more choice for the industry, pension scheme members and employers alike. The numbers who will potentially benefit are large.

Costs

13.37 The costs in this Regulatory Impact Assessment are based on the assessment in the original Regulatory Impact Assessment updated where appropriate to take account of changes proposed since then.

Transitional Costs to Industry

13.38 The pensions industry will have one-off transitional costs for systems changes, documentation and training, and for advice about transitional protection. Respondents to the original consultations said it would be difficult to accurately estimate these costs until they could study the full details of the legislation, including regulations, and also take into account proposed changes to DWP legislation. This remains the position to date.

13.39 Association of Consulting Actuaries (ACA) estimated that total industry transitional costs (for non-insured occupational pension schemes) would be in the

range of £150 - £250 million. This would be equivalent to costs of around £15 to £25 per member.

13.40 Within this category, the Association of Pensioner trustees (APT) representing the small specialised sector of small self-administered schemes, estimated that the transitional costs for their schemes (of which there are approximately 38,000 with almost 90,000 members) could be £60 million or almost £700 per member. This figure, however, assumed that all schemes would have to amend their documentation at transition, but the introduction of the Modification of Scheme Rules Regulations will ensure that schemes will not have to make immediate rule changes solely to ensure members' compliance with the new regime, allowing instead a window of up to 3 years from 6 April 2006 for schemes to make such changes.

13.41 The SIPP Provider Group estimated transitional costs for the whole of the SIPP industry to be in the region of £25 million. There are believed to be over 100,000 SIPPs, so this estimate equates to something less than £250 per SIPP arrangement.

13.42 Five large insurance companies estimated their own transitional costs, and these are on average around £12 million. From such a small number of responses it is difficult to project costs across the whole of the insurance industry, but given that those who responded were the larger insurers (one estimated that it held 12% of market share and another estimated around 12% for occupational pension schemes and 22% for personal pensions), these costs are unlikely to be typical for all insurance companies.

13.43 However, given the order of magnitude of the transitional costs outlined above, compared with the ongoing cost savings, covered in paragraph 4.4, it is likely that these transitional costs will be recouped within a few years of implementation.

Costs to Individuals

13.44 Most individual members of pensions schemes will not need to be concerned about the tax consequences of pension savings decisions, beyond knowing that they are getting tax relief on their pension contributions and that their pension income is taxable. A small number of people will need to declare, on their Self Assessment return, lifetime allowance charge liability (if they have taken benefits which exceed the lifetime allowance) or annual allowance charge liability (if they have exceeded the annual allowance). In order to assist such individuals in deciding whether they are liable to any of these charges, SA guidance notes will be published.

13.45 As a consequence of the legislative changes relating to inheritance tax, personal representatives of scheme members dying after age 75 with an alternatively secured pension (ASP) will need to declare the existence of the ASP in the estate's Inheritance Tax (IHT) return, with an estimate of the date of death value of the ASP funds and details of the scheme administrator (who will be liable for any IHT payable).

Cost to Government

13.46 The Government has also incurred one-off implementation costs, involving business change activities as well as new IT systems, in the region of £36 million over the course of 2003/04 to 2005/06. These costs have increased from the initial estimates as a result of the IT requirement being more fully defined and the decision to create a comprehensive online channel that will enable the government to move towards the mandatory filing of registrations, returns and reports. Pension Schemes Online will also enable individuals to make notifications for an enhanced lifetime allowance online.

13.47 These additional costs will be offset to some extent by the lower ongoing costs in administering tax relief for pensions, when the rules and procedures are simpler and the filing of reports and returns online is made mandatory. At this stage, it is too early in the process to estimate these with any degree of certainty but it is likely that they will be in the order of between £2m-£3m per annum. For public sector schemes, once they are in a steady state following the major program of reviews outlined in the December 2002 and June 2003 Pensions Green Papers (cm 5677 and 5835), the long term effects are likely to be broadly cost neutral.

On-Going Costs

13.48 The responses to the December 2003 document, where they have commented at all on this aspect, suggest ongoing savings rather than costs, once the transitional costs have been met. Few respondents gave any figures, and, as with transitional costs, they were in various different forms, making meaningful extrapolation difficult. However, the small number who did try to quantify this endorsed the Government's estimate of around 5% administrative savings, which had led to the original estimate of £80million per annum. This remains the Government's best estimate of the long-term savings arising from simplification.

Exchequer Effect

13.49 In 2004-05 the net tax relief for tax-approved private pension schemes was around £12 billion. This represents the up-front relief on contributions, plus the relief on schemes' investment returns, net of tax on current pensions in payment. This is in addition to over £6 billion relief given in exempting employer contributions from National Insurance.

13.50 The proposals will ensure these tax advantages will not only continue - but will grow. Current estimates of the Exchequer cost of the simplified pension regime are: 2006-07: £25 million, 2007-08: £70 million, 2008-09: £165 million, stabilising at about £250 million after 4 years. These costs include the likely impact of increased pension savings from those who are constrained by the current rules. They also take account of the increased flexibility offered by the new regime, such as the ability for some to take a higher tax-free lump sum than under the current regime or, for people in occupational schemes, to draw benefit from their pension scheme while continuing to work (if their scheme allows it).

13.51 However, the costs will depend to a large extent on behavioural changes and these figures are therefore best estimates. The range of uncertainty of the direct revenue effect of the measure increases the further into the future we look.

Small Firms Impact Test

13.52 Simpler tax rules, with lower administration and compliance costs, will be particularly helpful for small businesses. It will be easier and cheaper for employers to sponsor or contribute to a pension scheme for their employees. And, for the self-employed, the significantly more generous personal contribution limits of 100% of earnings will provide greater flexibility from year to year without the need for complex carry-back provisions. This greater flexibility has been widely welcomed across the pensions industry, although three respondents to the December 2003 document felt that the carry-back rules should be retained.

13.53 The Government believes, once the new rules are fully understood, that even those few that currently oppose this change will not be disadvantaged.

13.54 The impact of the pension simplification proposals, both on small businesses and across all sectors, has been open to two public consultations (see paragraph 2.5) including two series of open seminars. All the draft regulations have been published and HMRC have met to discuss responses to these draft regulations with interested parties. Since January 2003, HMRC have met every 6-8 weeks with representatives of all the main pensions industry bodies (the Pension Industry Working Group (PIWG)) to discuss progress on the project and operational issues. The feedback from these meetings has helped develop HMRC operational requirements post A-day.

13.55 HMRC have also met with Employer groups such as the Federation of Small Business to discuss the impact of the changes. The Association of Member Directed Pension Schemes, representing particular segments of small business, and the Small Business Service were engaged in direct dialogue with HMRC on the potential impact of these proposals. The culmination of the consultation process, and the impact on this sector, is summarised in the following paragraphs. The Small Business Service has seen the original Regulatory Impact Assessment and is satisfied with its content.

13.56 None of the subsequent changes to the original legislation will have a significant impact on this sector

13.57 The small businesses that provide pensioner trustee services to SSAs may be affected as the appointment of a pensioner trustee will no longer be mandatory, although schemes may nevertheless choose to retain their services. (There are approximately 280 approved pensioner trustees (P/Ts), although many of these also provide other services and not all are small businesses.) Twenty-five, mainly P/T, respondents, and the Association of Pensioner Trustees, which represents the majority of P/Ts, are not in favour of this change. Primarily, in support of their opposition, they cite increased compliance risks to the Exchequer from schemes without professional trustees.

13.58 The Government believes that the new compliance regime that will be put in place will adequately safeguard the Exchequer.

Competition Assessment

13.59 The reforms are intended to improve competition among financial services firms providing pensions. The complex rules of each of the current regimes, further complicated by the various regimes existing side by side, pose a significant barrier to entry for firms wanting to offer pension products. Anecdotal evidence suggests that firms are reluctant to begin to offer pensions because of the investment in systems and expertise required. If simpler rules can encourage more suppliers it should foster innovation and help drive down prices. The then Inland Revenue and HMRC have had many approaches during the consultation process, both formal and informal, about innovative product development and expects product design to flourish as a result of the new simplified rules.

13.60 It is not expected that there will be any adverse competition impacts. As the measures are significantly deregulatory there should be positive impacts on competition through lowering entry costs to the retirement savings market, or on diversifying to other sectors of it.

Equality Impact

Alternatively Secured Pension (ASP) **13.61** These types of pensions were not devised to be a mass market product, but to offer an alternative to the compulsory purchase of an annuity from an insurer, to meet the needs of those with conscientious objections on religious grounds, to the pooling of mortality risk. One group, in their response, said "...we are grateful for the provisions made to meet issues affecting our conscience before God".

Single Valuation Factors **13.62** The December 2002 consultation document proposed, for the purpose of determining the capital value of defined benefits, that the then Inland Revenue (now HMRC) would publish actuarial tables. This would have meant that a range of different valuation factors would have had to be applied to every member of a defined benefit scheme, to match their individual circumstances. In their response to the December 2002 consultation, both the Association of Consulting Actuaries and the Institute and Faculty of Actuaries strongly advocated the use of single unisex valuation factors to avoid this complication.

13.63 The Government responded by proposing single valuation factors (20:1 for lifetime allowance; 25:1 for pensions already in payment at A day; 10:1 for annual allowance).

13.64 Although this means that the proposed single factors will apply equally to everybody in defined benefit schemes irrespective of age, sex, dependants etc, the simplicity that this will bring for all has widely welcomed.

Enforcement, Sanctions and Monitoring

13.65 The present compliance regime for pensions is outdated by current standards. The new tax rules will incorporate modern and proportionate arrangements for awarding tax relief and preventing abuse. For both schemes and members there will be a self-assessment approach, with, in most instances, a "process now, check later" regime. There will be tax-geared penalties for non-compliance, that will be mitigated to take proper account of the size and gravity of the matter, and the willingness of those concerned to disclose and co-operate with enquiries. The tax-registered status of schemes will be withdrawn only in the most serious of cases.

13.66 Replacing the requirement to submit scheme rules and all subsequent amendments, for approval, with a simple registration system will reduce schemes' administration costs. While recognising the need to maintain an effective compliance regime, the Government has consulted with pension industry representatives about minimising the content, and targeting, of the new information returns, to ensure that schemes' compliance costs are kept as low as possible. As a result of this consultation, the content of the Pension Scheme Report (PSR) and Event Report (ER) have changed significantly. HMRC have made presentations to the Pensions Research Accountants Group (PRAG) (A sub set of the Institute of Chartered Accountants) and the Pensions Industry Working Group (PIWG) outlining the new strategy.

13.67 Following the issue of the second consultation document, HMRC organised five industry-wide seminars, and seven tailored specifically to IFAs, to explain the proposals. HMRC officials also spoke at or attended many other meetings and seminars organised by the pensions industry. Since then HMRC staff along with the pensions industry have organised and/or participated in more than 50 workshops or seminars to discuss pensions tax simplification and its impact. These have covered both operational and technical issues. Most of this material has been published on the HMRC website.

13.68 HMRC have also spoken at a number of events specifically aimed at employers. Comprehensive guidance in the Registered Pensions Schemes Manual (RPSM) for Pensions Technicians, Scheme Administrators, Employers and Individuals is being published on the HMRC website along with monthly Newsletters covering topics of particular interest.

Implementation and Delivery Plan

13.69 For details of the Implementation and Delivery Plan, please refer to Annex C.

Post-implementation Review

13.70 HMRC plans to carry out an evaluation of the Pension Tax Simplification measures. The evaluation involves external research, analysis of administrative data and secondary analysis of survey data to enable HMRC to monitor the impact and effectiveness of the Pension Tax Simplification measures over time. Baseline research is already underway in 2005/06 and will continue in 2006/07 with Employers, Individuals, and the Financial Services Industry. Given the longer-term nature and likely impact of pension reforms it is expected that further external research will be conducted over a number of years to measure the impact of the Pension Tax Simplification measures over time.

13.71 In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Summary and Recommendation

13.72 Pension tax simplification will simplify the taxation of pensions by replacing the current complex regimes with a single universal tax regime for all pensions with both a lifetime limit and annual limit on the amount of pension savings that can benefit from tax relief, making it easier for consumers to understand pensions, cheaper for employers to provide them, reducing unnecessary administration and the cost of advice.

13.73 The new compliance rules will be simpler than those of the current regimes and will focus information requirements on areas of risk. Schemes will be required to report information electronically, enabling risk assessment and targeting of compliance to take place in areas where it is needed. Sanctions on schemes and members will be imposed where funds are improperly removed from a pension fund or reporting requirements are not met.

13.74 The new legislation follows two periods of consultation in which the Government put forward its proposals for the simplification of the taxation of pensions in two consultation documents:

- “Simplifying the taxation of pensions: increasing choice and flexibility for all” published in December 2002, and
- “Simplifying the taxation of pensions: the Government’s proposals” published December 2003.

13.75 HMRC has continued to consult with key stakeholders and pensions industry representatives throughout the drafting of the legislation and regulations to ensure a smooth transition to the new regime. Initially the proposed implementation date was April 2005, but following representations from the pensions industry this was put back

until 6 April 2006. HMRC has also published detailed guidance to the new legislation aimed at pension schemes, practitioners, employers and individuals on its website.

13.76 A link to the Registered Pension Schemes Manual can be found at the end of this document.

KEY MILESTONES

- PBR 2002: Government publishes proposals for reform of taxation of pensions in consultation paper
- PBR 2003: Government publishes further proposals for reform in response to consultation
- Budget 2004: Government announces its intention to proceed with the implementation of simplified tax regime
- April 2004: Finance Bill 2004 legislates for reforms
- March 2005: HMRC begins publication of draft Regulations relating to pensions tax simplification
- April 2005: Finance Bill 2005 includes further detailed changes
- June 2005 onwards: Publication on HMRC website of Registered Pension Schemes Manual – a comprehensive guide to simplified tax regime for pensions.
- PBR 2005: Government announces further changes to the simplification legislation including the removal of tax advantages from self directed registered pension schemes investing in residential property and certain other assets.
- April 2006: Simplified tax rules for pensions take effect.

LINKS TO DOCUMENTS MENTIONED IN THIS REGULATORY IMPACT ASSESSMENT

- **HMRC Technical Note of 16 February 2005**

<http://www.hmrc.gov.uk/pensionschemes/pensions-simplification-tn.pdf>

- **HMRC Pre-Budget Report Technical Note of 5 December 2005**

<http://www.hmrc.gov.uk/pbr2005/pensions-simplification.pdf>

- **NAO Report**

http://www.nao.org.uk/publications/pensions_estimates_march_04.pdf

- **Registered Pension Schemes Manual**

<http://www.hmrc.gov.uk/pensionschemes/rpsm.htm>

- **Pensions Simplification RIA of 8 April 2004**

<http://www.hmrc.gov.uk/ria/simplifying-pensions.pdf>

- Pensions Simplification RIA 3 March 2005

<http://www.hmrc.gov.uk/ria/simplifying-pensions-appendix.pdf>

Annex A: Existing Approved Pensions Tax Regimes

A.5 This annex provides a brief overview of the current six tax privileged regimes for pensions. In reality, the rules are far more complex, but this table summarises the key rules and differences.

Old Code for Employees Joining Pre-1970

A.6 Schemes no longer able to accept contributions since 6 April 1980, but scheme investments continue to be tax exempt and benefits can still be paid out. Benefits are subject to output limits. Retirement lump sum could only be paid from separate scheme, which had less tax privileges.

Pre 87 regime for employees joining between 1970 and 1987

A.7 Contributions:

- employers can make unlimited contributions; and
- employees contributions limited to 15% of (uncapped) salary

A.8 Benefits:

- maximum lump sum limited to 1.5 times (uncapped) final salary, after 20 years service (subject to an escalating scale below 20 years), not linked to size of pension;
- maximum pension limited to 2/3 of (uncapped) final salary after 10 years service (subject to an escalating scale below 10 years);
- different formulae for early leaving and early retirement; and
- different rules for retained benefits (ie benefits from previous occupations).

A.9 Status:

- members of such schemes can continue to accrue benefits under this regime while they remain in the same employment.

1987 regime for employees joining between 1987 and 1989

A.10 Contributions:

- no change from pre 1987 (above).

A.11 Benefits:

- maximum lump sum limited as for pre 1987 but further limited to £150,000 (not indexed); and
- maximum pension limited to 2/3 of (uncapped) final salary after 20 years service.

A.12 Status

- members have similar rights to pre-1987 , with some minor changes to the rules governing changes in employment.

1989 regime for employees joining from 1989**A.13** Contributions:

- employers can make unlimited contributions; and
- employees contributions limited to 15% of capped salary (originally £60,000, indexed by RPI, £102,000 for 2004/05).

A.14 Benefits:

- maximum lump sum limited to 2.25 times initial pension or 3/80th of final capped salary for each year of service (max. 40 years); and
- maximum pension limited to 2/3 of final capped salary after 20 years service.

A.15 Status:

- applies to all new members and schemes.

Retirement Annuity Contracts (RACs) for individuals commencing contracts pre- 1988**A.16** Contributions:

- age related input limit, based on uncapped earnings. Max contribution for those aged 61 to 74 is 27.5%.

A.17 Benefits:

- must purchase an annuity with the pension fund, no later than age 75; and
- able to receive lump sum related to the size of annuity purchased.

A.18 Status:

- Existing investors can still make contributions, but unable to start new contracts since 1988; and
- contributions to personal pensions are restricted for those already making contributions to RACs.

Personal Pensions for individuals with earnings and not in occupational schemes from 1988; and for non-earners and certain occupational scheme members from 2001**A.19** Contributions:

- maximum contributions limited to a % of earnings, increasing with age (from 17.5% prior to age 35 rising to 40% from age 61 to 74); and

- earnings restricted to same earnings cap as “1989 regime” (£102,000 for 2004/05).

A.20 Benefits:

- must purchase an annuity with the pension fund, no later than age 75; and
- lump sum up to 25% of fund.

A.21 Status:

- applies to all new investors and schemes.

A.22 Stakeholder pensions are part of this regime

Annex B: Further Pension Simplification Measures Announced 5 December 2005

Residential Property and Other Assets

B.1 From 6 April 2005, the Government will remove tax advantages for investing in residential property or certain other assets such as fine wines, classic cars and art & antiques from registered pension schemes which are self-directed. This is to prevent people benefiting from tax relief in relation to contributions made into self-directed pension schemes for the purpose of funding purchases of holiday or second homes and other prohibited assets for their or their family’s personal use.

Recycling of Tax-Free Lump Sums

B.2 New tax legislation to counteract artificial tax relief gained by the recycling of tax-free lump sums withdrawn by members from their registered pension scheme and subsequently reinvested

Protected Pension Age and Industry-wide Employers

B.3 Retention of protected pension age in certain circumstances on re-employment with the same employer or a different sponsoring employer for the same scheme.

Definition of a Pension Credit Member

B.4 Extension of the definition of “member” in Section 151 Finance Act 2004 to include a former spouse who dies in the period between a court ordering a pension share and the pension share actually coming into effect

Definition of Member and Employer

B.5 Extended to include ex-members and employers who have ceased to be sponsoring employers, for the purpose of the unauthorised payment charge at Section 208 Finance Act 2004.

Lump Sum Death Benefit Rules

B.6 Legislation to ensure that lump sum death benefits may be paid in circumstances where an annuity or pension is purchased from a drawdown fund.

Transitional Provisions

B.7 Three incorrect references in Schedule 36 Finance Act 2004 will be corrected.

B.8 Further details of these measures are contained in HMRC's Pre-Budget Report Technical Note, which can be found at: HMRC Pre-Budget Report Technical Note of 5 December 2005

Annex C: Pension Simplification – Information for the Implementation and Delivery Plan

Question	Answer
Returns and Reports	
What is likely to be the main administrative burden on Pension Schemes?	Returns will be required from small occupational schemes – of which there are some 40,000 - and some Personal Pension Providers when their members are involved in particular types of transaction. When certain types of payment are made to members of schemes there will be tax charges requiring schemes to make payments to an Accounts Office with a corresponding return to Audit, Pensions & Share Schemes. On the occurrence of specified events of certain events, or certain rule or structural changes a report will need to be made to HMRC.
What new forms is the policy introducing?	There will be an Accounting for Tax Return (AFT), an Event Report (ER) and a Pension Scheme Return (PSR) to deal with the above.
What data are HMRC asking for on these forms?	<p>The AFT will require schemes to provide designatory information about the recipients of certain scheme payments along with details of the amount of the payment and the tax due.</p> <p>The ER will require details of certain events, mainly concerning some specific situations where it is likely that there will be a tax charge or where a payment might be made when there is risk that the payment is being made in order to avoid a tax charge.</p> <p>Neither return is required if there is nothing to report.</p> <p>The PSR will require details of certain types of transaction, particularly with connected parties, about shares, loans and property. Similar information will be require about</p>

	arms length transactions but in less detail.
Is it data that is likely to be held already?	Existing data.
Co-operating with Tax Authority / Carrying Out Inspections	
What will the compliance regime for this policy be?	The information from the returns and reports outlined above will be captured electronically and risk assessed along with other 3rd party information to decide whether the scheme represents risk of unpaid tax. Enquiries will be made as necessary to satisfy HMRC that the Returns etc. are correct. Where it is not possible to risk assess, e.g. because of an absence of electronic data then enquires will be selected on a random basis.
What additional information might HMRC ask for?	This will depend on the nature of the enquiry but could include bank statements, scheme documentation concerning its rules, correspondence with members, trustees annual reports and evidence to support claims that particular payments to members were not subject to tax.
How often might HMRC request such information?	We expect to make about 600 enquiries each year and it would be exceptional for any one scheme to be subject to more than one such enquiry.
Are we asking registered pension schemes to be audited or inspected by a third party?	No
Framing Appeals and Complaints. (Note we're interested in a Compliant Pension Scheme here)	
If something goes wrong, what is the appeal process?	Pension schemes are generally exempt from tax on their investment income and capital gains. There can be tax liabilities in exceptional circumstances, mainly if schemes make unauthorised payments or when schemes make authorised payments requiring the payment of tax, which appears to be an incorrect amount. There will be a good faith let out in appropriate circumstances with a right of appeal. Assessments will be made when it appears to HMRC that the amount of tax paid by the scheme in respect of an authorised payment is incorrect and it has not been possible to reach agreement with the scheme as to the correct amount payable. In those circumstances appeals can be made to

	Commissioners and then to the courts on questions of law.
If a claim is rejected, what recourse do pension schemes have?	There will be recourse to Tax Commissioners.
What information might a pension scheme have to provide for an appeal? Is this something that they would be likely to have prepared (e.g. accounting data?)	This would depend on the nature of the appeal but would be correspondence, bank statements, scheme records of one sort or another or perhaps copies of scheme documentation such as its rules. It is very unlikely that schemes would need to prepare data that was not already in existence.
Providing Statutory Information to Third Parties	
Are HMRC asking pension schemes to provide information to third parties as well as HMRC?	Yes
What form does this information take?	The form will be a matter for schemes to decide.
What data are HMRC asking them to provide?	Each individual is entitled to a Lifetime Allowance of pension saving amounting to £1.5 million at 6/4/06. It will increase in stages to £1.8 million by April 2010 but is initially fixed at £1.5M. Any excess over that amount will be taxed. Schemes will need to provide their retired members with an annual statement setting out their pension as a percentage of the LTA.
Is it data that they're likely to hold already, e.g. accounting data?	Yes
Is it information that they would provide anyway, even if not required by HMRC?	No
Keeping Records	
What records are HMRC asking pension schemes to keep?	There is a requirement for scheme administrators, trustees and any person who provides administration of the scheme to retain records of monies received by or owing to the scheme, any investments/assets of the scheme, payments made by the scheme, contracts to purchase annuities in respect of scheme members and the administration of the scheme. If the scheme is an occupational scheme then a sponsoring employer or director of an employer company is also required to retain such records. The obligation remains when a

	person ceases to act – for example where he has transferred all documents to another person in relation to the scheme.
How long are HMRC asking them to retain them for?	The tax year to which they relate and the following 6 years.
Are the information requirements explicitly stated in legislation?	Yes, in Regulations.
Application for Credit	
Entry in the Register / Registration	
Does the policy require pension schemes to register?	If a Pension scheme requires tax relief then they must successfully register the pension scheme.
What form will this registration take?	An application for registration can be made on a paper form or online.
What information will be required?	All questions on the registration form (paper or online) are mandatory. These will include Scheme name, schemes legal structure, number of members in the scheme, Establisher details & whether the scheme has at least one member with the ability to control the way in which the scheme assets are used. A declaration must then be completed.
Applications for Authorisation	
Does the policy require pension schemes to request authorisation before an event can take place (e.g. advance clearance of share sales)?	No
Application for Guidance	
Can pension schemes ask HMRC for guidance?	HMRC have produced a detailed Guidance Manual with sections specific to our different customer base – Technical, Administrator and Member. This is available via the Internet and in pdf format and will enable customers to “self-serve” without the (general) need to contact us. As is the norm with new legislation, where a point remains unclear or is not covered within the Guidance, customers can ask for our opinion via the Code of Practice procedure – CoP 10.

What information does HMRC need before it can offer guidance?	The normal requirements for a Code of Practice (CoP) request apply – all the facts and circumstances have to be given, together with the customer’s view of the likely solution.
How often are pension schemes likely to apply? One off, or on a change of circumstances?	Each CoP 10 request will relate to a “one off” situation. We will monitor such requests and where it becomes clear that the Guidance needs to be amended or expanded, we will do so quickly to reduce the need for future requests.

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14

REGULATORY IMPACT ASSESSMENT FOR RELIEF FROM THE 40% TRUST RATE

RELIEF FROM THE 40% TRUST RATE OF TAXATION FOR SERVICE CHARGE AND SINKING FUNDS IN THE SOCIAL HOUSING SECTOR

Purpose and Intended Effect of Measure

The Policy Objective

14.1 The proposal will provide relief from the 40% rate of taxation applicable to trusts service charge and sinking funds in the social housing sector. They will instead be subject to income tax at the basic or lower rate. Because most forms of investment income are taxed in this way at source no further tax will be payable.

14.2 The measure will de-regulate Registered Social Landlords (RSLs) and others in the social housing sector and will reduce the administrative burden on HMRC.

Background

14.3 Service charges are collected from tenants of leasehold property. They cover the day-to-day repairs and maintenance costs of the property. In order to provide funds for long term dilapidations and repairs a portion of the charges is saved up – this portion is called a “sinking fund”. Service charge and sinking funds in the private sector are required to be held in trust funds for the tenants (section 42 Landlord and Tenant Act 1987), which ring fences them from the landlord and ensures that the tenants are entitled to any surplus in the funds over the cost of repairs etc. Section 42 does not apply in the social housing sector, but RSLs have on advice been holding service charge and sinking funds in trust to benefit the tenants of their properties.

14.4 The measure proposed here is mainly of relevance to sinking funds as service charges are normally spent during the year.

14.5 Sinking funds are normally invested in interest bearing bank accounts or other similar investments. Following changes to trust taxation in 2004 the rate of income tax applicable to trusts was increased to 40%, and the dividend trust rate to 32.5%. The intention was to deter the use of trusts for tax avoidance purposes, but a consequence was that sinking funds attracted the special trust rates even though they are not used for tax avoidance.

14.6 In Finance Act 2005 an exemption from the full rate of 40% was provided for the first £500 of trust income. The exemption was intended to benefit small trusts including service charge and sinking funds. The first £500 is taxed at the basic or lower rate of tax instead of 40%. Another exemption was also introduced for trusts for the vulnerable. In those cases the income is taxed taking into account personal allowances and rates bands for the beneficiary instead of at the special trust rates.

14.7 In the social housing sector, RSLs have been collecting money on behalf of tenants to pay for sinking funds. There is no statutory requirement that this money is held on trust but it is wise for the RSL to do so. Interest and other income arising on these trusts is taxable at 40% unless the income is less than £500. We have discovered that many of the funds in the social housing sector are very large and therefore derive little benefit from the £500 standard rate band.

14.8 There is also some doubt that RSLs are aware of their tax obligations as trustees, exposing themselves to the risk of HMRC action to recover undeclared tax. We have been told that some RSLs may have been advised that their sinking funds are not trusts, but the view of HMRC is that this is not the case.

14.9 It could also increase the long term need for grants to cover renovations by reducing the returns on sinking fund savings, unless service charges increase to cover any shortfall.

14.10 There is also an indirect connection with housing benefit costs. Many of those in social housing are in receipt of housing benefit, and the cost of the housing benefit (which will cover costs such as service charges) would be greater in the long term if service charges need to be higher to compensate for additional taxation.

Rationale for Government Intervention

14.11 The Office of the Deputy Prime Minister (ODPM) is the Government Department with primary responsibility for social housing. The Housing Corporation, an agency of ODPM, regulates and funds RSLs, the main providers of new social housing. They are concerned that the imposition of the 40% rate on RSL sinking funds is a regulatory burden and that it could be seen as unfair to tax social housing tenants at the same rate as wealthy tax avoiders. ODPM/Housing Corporation encourage sinking funds to ensure that sufficient funds are available for the major repair or properties and to help low cost home ownership purchasers sustain home ownership.

14.12 Current tax yield from sinking funds in the RSL sector might be just under £5m (HMRC data does not allow a precise estimate) and this measure will forego about half of that costing about £2.4m a year in lost tax income.

14.13 This measure has no EU implications.

Consultation

Within Government

14.14 Consultation within Government was across HM Treasury, HMRC, and ODPM.

Public Consultation

14.15 Consultation has been conducted by approaching the Housing Corporation, The National Housing Federation, The Association of London Government, the Local Government Association, and the executives of the other nations. These are all bodies with an interest in social housing.

14.16 Consultees either did not respond or welcomed the proposal.

Options

14.17 We have considered a range of options.

1. Do Nothing

14.18 This option would save the tax cost but would mean that RSLs continue to face a regulatory burden through tax compliance. It would also keep the tax rules simple by avoiding a special rule. However, residents and social landlords may be deterred from

making adequate provision for the future major repairs through sinking funds by the 40% tax rate.

14.19 This option requires no delivery planning.

2. Complete Exemption

14.20 This option would provide that RSL and local authority sinking funds are completely free of tax and could recover tax suffered through deduction at source. This has been requested by the Housing Corporation and ODPM. It would maximise the benefits to RSLs by minimising the exposure of the sinking funds to tax. But it would mean that these trusts have to submit claims to tax repayments as most types of investment income are taxed at source. It would therefore not be deregulatory for RSLs or HMRC.

14.21 Checking claims for refunds would place an administrative burden on HMRC. It would cost also about double the estimate for option 4. Exemption would look inconsistent with rules on trusts for the vulnerable and other types of trust, which might also be considered to be not for tax avoidance. It would also raise many “me too” requests, for example from tenants in the private sector.

14.22 This option would require RSLs to be informed how to claim refunds of tax, and HMRC to train its staff to process them. It would also require additional operational staff in HMRC.

3. Extension of the £500 threshold for RSLs

14.23 A £500 threshold for all trusts was introduced in 2005. This provides that the first £500 of income is taxed at basic or lower rate and that the 40% rate only applies to income in excess of £500. An extension of the threshold for the sector was rejected as some RSL sinking funds have considerable income and evidence suggests that wherever the line was drawn some would be over it. This option therefore has little to offer in advantages except that it had a reduced tax cost to other options.

14.24 This option would involve RSLs being informed about how the provisions work and also HMRC would examine returns to ensure the conditions are met and the threshold not breached. It will require more policing than option 4.

4. Providing basic or lower rate taxation for all income of RSL service charge and sinking funds

14.25 This would go further than option 3 by providing that all of the income of RSL sinking funds is taxed at basic or lower rate. This option has the best regulatory outcome as it would mean that as long as the fund only receives taxed income such as UK bank interest it will have no further tax obligations. It will also mean that HMRC will not have to process returns.

14.26 This option requires HMRC to inform RSLs and their own staff about the change, but implementation will not have significant impact on HMRC (and will be simpler than options 2 and 3).

14.27 This option is the preferred option. The Government propose that where an RSL holds funds on trust for the maintenance etc. of a property, the income from the fund is exempt from the charge to tax at the special trust rates under section 686 ICTA 1988, but

instead charged at the appropriate income tax rate depending on the nature of the income.

14.28 For this purpose RSLs will be defined by reference to the definition in the Housing Act 1996. 'Service charge' and 'sinking funds' will be defined by reference to the definitions in LTA 1987.

Costs and Benefits

Sectors Affected

14.29 The business sector affected by the measure would be those who are managing social housing on behalf of tenants. This sector is mainly local authority or charitable.

14.30 The proposal has no race, NI or equality impacts.

Benefits

Benefits to the Exchequer and Administrative Burdens

14.31 The measure clarifies the tax treatment of sinking funds in the social housing sector for those in doubt.

14.32 There is scope for reduction of demand on public finances either through grants or increased housing benefit to top up service charge and sinking funds. This cannot be quantified.

14.33 It will reduce the administrative costs of HMRC and will marginally reduce the risk that public grant will be needed to help pay for repairs to social housing in the future.

14.34 The proposal will reduce the bureaucracy and administrative costs of RSLs by removing the obligation to make annual tax returns (unless the RSL is in receipt of untaxed income).

Environmental and Social Benefits

14.35 None. But there is a small indirect benefit in making it easier for social housing to be maintained to a high standard through increasing the returns of sinking funds.

Costs

Costs to the Exchequer

14.36 The proposal will cost less than £2.5m. While this is based on scaling up a small sample the assumptions used to do that were chosen cautiously.

14.37 The proposal could increase calls for other types of trust to be taxed in a special way.

Other Costs

14.38 The proposal has no additional environmental, social or economic costs.

Small Firms Impacts Test

14.39 For the purposes of this RIA we assume that the charitable RSL sector will qualify as small businesses.

14.40 We have not approached any RSLs directly about the proposal although we have spoken to ODPM and the Housing Corporation. The measure is intended to reduce taxation and remove a burden, as requested by the Housing Corporation and ODPM. It will benefit both small and large RSLs; the benefit to smaller RSLs may be disproportionately more valuable.

Competition Assessment

14.41 The tax aspects of this proposal will benefit individuals and not businesses.

14.42 It will only affect businesses to the extent that the tax and administration costs of the current regime get passed from RSLs onto tenants and leaseholders

14.43 The regulatory aspects will benefit the grant funded RSL sector. Arguably this will marginally improve the regulatory burden on that sector compared with private landlords, but on the evidence we have these markets are distinct and have little overlap. In the private sector, where such service charge and sinking fund trusts exist they are normally managed by tenants and not landlords (depending on the terms of the lease).

Enforcement, Sanctions and Monitoring

14.44 For all options the measure is a tax relief within the self-assessment system and we expect it to be self-policing. It is a tax relief and levels of compliance are likely to be high.

14.45 No new sanctions are required.

14.46 No additional costs are imposed except for Option 2 above where full refunds would have to be claimed.

Implementation and Delivery Plan

14.47 The new tax rules will take force for income arising in the relevant sinking funds from 6 April 2006. They will need to be taken into account in making tax returns after the end of the 2006 / 7 tax year by the deadline of 31 January 2008.

14.48 HMRC will publicise the change as part of their Budget change publicity, and issue instructions to staff within 3 months of the Budget announcement.

14.49 HMRC Trusts, Settlements and Estates manual will be updated by 5 April 2007. The guidance for the Trusts and Settlements pages of the Self-Assessment tax return will be updated in time for the 2007 return issue. Changes to the return itself will not be needed. Internal guidance will be made public.

14.50 Trust tax returns It will remove the obligation on social housing sinking funds to notify chargeability to HMRC. ODPM will monitor the development of sinking funds in England and evaluate the success policy measure in 3 years time.

14.51 ODPM will publicise the change through the housing corporation.

Post-implementation Review

14.52 ODPM will monitor the development of sinking funds in England and evaluate the success of the policy in 3 years time.

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REGULATORY IMPACT ASSESSMENT

Relief from the 40% Trust Rate for Service Charge and Sinking Funds in the Social Housing Sector

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 7 March 2006

Purpose and Intended Effect of Measure

The Policy Objectives

15.1 The policy objectives of the Trust Modernisation package are to reform the income tax and capital gains tax (CGT) system for trusts, to provide greater consistency of approach between income tax and CGT in relation to the taxation of trusts, and, following on from measures introduced in the Finance Act 2005, to continue to reduce tax compliance burdens on smaller trusts.

15.2 The changes will apply to the whole of the UK.

Background

15.3 Finance Act 2004 increased the rate applicable to trusts (RAT) to bring it in line with the higher rate for income tax. However, since it was recognised that this could have an impact on smaller trusts, trusts with vulnerable beneficiaries and other trusts whose beneficiaries are not higher-rate taxpayers, Finance Act 2005 introduced a standard rate band for all trusts that pay tax at the dividend trust rate or the RAT and a new regime for certain trusts with vulnerable beneficiaries.

15.4 The Government recognise that the taxation of trusts can be a complex area and particularly challenging for non-professional trustees. The measures being introduced at Finance Bill 2006 (as impact assessed in the regulatory impact assessment) aim to align the main tests and definitions for income tax and CGT and, therefore, reduce the burden of administering the taxation of trusts.

Rationale for Government Intervention

15.5 The proposals will make the taxation of trusts more consistent across the income tax and CGT regimes and therefore reduce administrative burdens on trustees, especially the trustees of smaller trusts.

Consultation

15.6 A series of discussion papers was published in December 2003, setting out a number of initial proposals for modernising the taxation of trusts. This was followed by a consultation paper in August 2004. The summary of responses to the consultation was published on 16 March 2005, accompanied by a Regulatory Impact Assessment.

15.7 The Chancellor announced proposals for two new measures for modernising the tax system for trusts at Budget 2005. Legislation for these measures was included in the Finance Act 2005.

15.8 The Government also asked the Inland Revenue (now HMRC) to discuss further with interested parties some of the more detailed aspects of the proposals. The discussion paper was published on 16 March 2005. The summary of the responses was published on 31 January 2006.

15.9 As a result of discussion, draft legislation and explanatory notes for the measures being brought forward at Budget 2006 were also published on 31st January

2006, accompanied by a Partial Regulatory Impact Assessment, for comment. The deadline for responses to the draft legislation was 17th February 2006.

15.10 We received 32 responses to the draft legislation. There were some requests for the legislation to come into effect in April 2007, and some concerns expressed regarding the change to the settlor-interested rules for CGT (please refer to paragraph 15). Many respondents opposed this change on the grounds that it will stop parents who settle business assets on their dependent children claiming relief from CGT on the gift. In general, the remainder of the proposals were welcomed. Helpful contributions were received on several detailed aspects of the draft legislation.

Options

1. Do Nothing

15.11 Although this option was considered, given the commitment made by Ministers at the time of introducing the increase in the RAT, and the discussion and consultation that followed, this option has not been recommended.

15.12 In response to the discussion papers and in meetings with representative bodies, the proposed changes were welcomed and the consensus has been that these should, where possible, be taken forward as a package.

15.13 The do nothing option would mean that inconsistencies in the way we tax trusts would remain, and the further reduction in the administrative burden for small trusts which is one of the benefits of this package, would not be realised.

2. Summary of new legislation being introduced (chosen option)

15.14 Legislation for the measures outlined in the following paragraphs will be included in the Finance Bill 2006.

Increase in Standard Rate Band

15.15 This will be raised from £500 to £1000. Below this level, trustees' income will be assessable at no more than the basic rate of income tax (currently 22%), which means that many trustees whose income is taxed at source will have no additional tax to pay. Those trusts with income consistently below £1000 will no longer need to complete an annual Self Assessment return.

Common Meaning of Settlement

15.16 This will align what is treated as a settlement for the general purposes of income tax and tax on chargeable gains. The meaning of 'settlement', which will apply for both income tax and tax on chargeable gains will be that which currently applies for the purposes of the Taxation of Chargeable Gains Act 1992 (TCGA) except where the broader anti-avoidance meaning given in section 620 of the Income Tax (Trading and Other Income) Act 2005 specifically applies.

15.17 The effect is that income tax will be charged on income arising to the trustees of a 'settlement' with the definition of settlement being derived from existing trust law and case law, and 'settled property' being defined in the tax legislation. The trustees of a settlement will be treated as a single person for income tax and TCGA purposes.

Common Residence Test

15.18 A common test will provide consistency and clarity for trustees and advisers. The common residence test which is to be adopted for the purposes of both income tax and tax on chargeable gains, is to be modelled on the current income tax test, based initially on the residence status of the trustees, and using the residence and domicile

status of the settlors as a tie-breaker where the body of trustees contains a mixture of UK resident and non-UK resident persons. The test will become effective from April 2007 in order to allow trustees the time to re-order their affairs in relation to their residence status.

15.19 We had also proposed to extend and modify the current professional trustee test, which applies for the purposes of chargeable gains and apply the modified test for purposes of both income tax and chargeable gains. However, we have been advised that this would constitute a State Aid, so this aspect of the Trust Modernisation proposals has been withdrawn.

Sub-fund Elections **15.20** Where assets of a single settlement have been split off into separate sub-funds administered on behalf of different beneficiaries, often by different bodies of trustees, the trustees of the settlement will be able to elect for the sub-funds to be treated as if they were separate settlements for income tax and TCGA purposes. This will reduce administrative burdens where separate sets of trustees within a single settlement are, at present, required to work together to prepare a single CGT computation.

15.21 This change provides for the making of an election to give rise to a disposal of the property comprising the sub-fund in question for the purposes of tax on chargeable gains, providing parity of treatment with trustees who use a power to settle property out of an existing settlement into a new settlement.

Harmonisation of Settlor Interest Tests **15.22** For TCGA purposes a settlement will be regarded as settlor-interested if a minor child (or step-child) of the settlor who is neither married nor in a civil partnership can or does benefit from the settlement during the tax year in question. This will bring the TCGA treatment more closely into line with the income tax treatment.

Retention of Character of Income **15.23** The income of all settlor-interested settlements will retain its character as it flows through the settlement, so that in the hands of a settlor it will be taxed at the same rates as it would had it arisen directly to him or her. This removes unhelpful anomalies in the rates of tax applying to settlors in such cases.

Single Charging Mechanism **15.24** A single charging mechanism will be introduced to ensure that capital items deemed to be income for tax purposes are brought into charge at the special trusts rates in a consistent way. Items that are capital in trust law but deemed to be income for tax purposes will be brought into charge as income of the trustees at the RAT or dividend trust rate as appropriate.

Beneficiaries of Settlor Interested Trusts **15.25** New legislation is being introduced to ensure that payments to beneficiaries of settlor-interested trusts will not be chargeable in the beneficiaries' hands.

Deferred Provisions

15.26 The following proposals had been suggested in previous consultation and discussion papers. However, we have encountered some difficulties in working out the detail of the proposals. They have therefore been deferred until a later date.

Allow Income to Stream through a Trust to a Beneficiary **15.27** The income streaming proposals are an important element of the Trust Modernisation package and were broadly welcomed in consultation, though some concerns were expressed about the potential of this proposal to increase the complexity of the tax system for trustees. We consider that the proposal is necessary to allow the full benefits of the changes made already to be delivered. However, we have

encountered some difficulties in ensuring that income streaming works properly for all classes of trustees and need to explore further how the proposals will fit with existing legislation and practice. Further work will be taken forward with a view to introducing this measure at a later date.

Abolish the Tax Pool **15.28** This change would particularly benefit smaller trusts and enable them to realise fully the benefits of the new measures introduced in the Finance Act 2005. However, this proposal is inextricably linked to the income streaming proposal described above, and so work on this will be taken forward with the aim of introducing both measures at a later date.

Chargeable Gains of Estates **15.29** The proposal is that the personal representatives of a deceased person would be chargeable to CGT on gains arising from the estate at the rate of 20% up to a specified limit in the tax year of the deceased's death and the succeeding two tax years. This reduced rate of CGT would better reflect the personal circumstances of many beneficiaries who are lower or basic rate taxpayers and who would not normally pay CGT at the 40% rate. This measure is being deferred to a later date when it will form part of a wider package of measures to improve the tax treatment of estates.

Costs and Benefits

Sectors and Groups Affected

15.30 These measures will affect trustees of settlements and those advising or acting for trustees. This could include professional trustees, the legal profession, accountants, banks and lay trustees.

15.31 The Trust Modernisation package will reduce the burden of administration for settlements, especially benefiting lay trustees, by providing a more consistent approach to the taxation of income and gains arising in respect of settled property. What constitutes the "settlement" will be the same for income tax and TCGA purposes, and the residence status of the trustees of the settlement will be the same. The package should have an overall positive impact on those affected by the changes.

Benefits

15.32 The benefits of the changes being introduced will be:

- a reduction in the number of trusts within the SA regime;
- a more consistent approach to taxing trustees' income and gains;
- clearer tax rules relating to settlements; and
- a further reduction in the burdens on smaller settlements.

Costs

Policy Costs

15.33 There will be increased short-term costs for HMRC as a consequence of these changes. Staff will be made aware of the changes introduced and guidance, internal and external, will be produced and amended as appropriate. As well as the amendments needed to be made to the tax return for trustees, the tax return for individuals will need

to be amended in order to cope with the changes in the definition of settlor-interested settlements.

Compliance Costs

15.34 The changes will not have a significant impact on trustees' compliance costs as most of the changes are designed to improve consistency in the way the tax system operates. Much of the definitional legislation will codify and clarify what already happens in practice.

15.35 In order to mitigate the risk that people may try to exploit the standard rate band by setting up several small settlements instead of one larger one, a new test will be introduced to ensure that a group of settlements established by the same settlor can benefit from only one standard rate band.

15.36 There may be a cost associated with trustees and advisers having to familiarise themselves with the changes.

Exchequer and Distributional Effects

15.37 Overall, there are negligible costs to the Exchequer arising from the changes being introduced as part of this Trust Modernisation package.

Other Impacts

Devolution

15.38 None at present. We are aware that there are differences between the underlying law relating to settlements in different parts of the UK, but most of the responses received in consultation have indicated the changes will work consistently throughout the UK.

Human Rights

15.39 There are no implications under the Human Rights Act.

Environmental

15.40 None.

Rural Proofing

15.41 None.

Small Firms Impact Test

15.42 We consider that the impact of the changes on small businesses will be minor and any impact that is felt is likely to be beneficial. Generally, trustees do not run small businesses and so small businesses will be unaffected by the measure. There may be an indirect effect on professional firms which happen to be small businesses in their own right.

15.43 The impact of the changes will be felt by trustees and settlors of settlements, which will include small settlements. From our data, there were around 170,000 small

settlements in the tax year 2003/04 where we have defined a 'small settlement' as one having a tax bill of less than £1000 a year.

15.44 In particular, the trustees of smaller settlements will benefit from the increase in the limit of the standard rate band, and there should be a reduction in administrative burdens gained from the modernisation of the taxation of trusts. One example of this is the common residency test which will mean that those settlements with different residence status for income tax and CGT purposes will, in the future, have the same UK residence status for both taxes, reducing the burden of complying with the tax regime for settlements.

15.45 From our consultation and discussions with representative bodies, we feel that this view is held in common with trust professionals, though as indicated above some concerns have been expressed about particular aspects of the changes.

Competition Assessment

15.46 It seems reasonable to define the market affected by the Trust Modernisation package as limited to those firms, which offer services in the area of settlements. This includes professional trustees, some banks and legal and accountancy firms. These are likely to act for settlements in either an advisory or fiduciary manner, or both.

15.47 The 'settlements' market is a specialist field and not controlled by any dominant firm. The Trusts Modernisation package will modify aspects of the income tax and TCGA rules for all settlements and as such should not affect some firms more than others. Any increase in compliance costs for trustees as a result of the proposed change should be negligible, and indeed, the new system should reduce the administrative burden on many trustees, especially the trustees of smaller settlements, which have already benefited from the introduction of the standard rate band.

15.48 The changes will affect all the firms dealing with settlements in the same way and it is unlikely that the proposals will result in any changes to the market structure. New firms should not be affected disproportionately. The package will also prevent any tax avoidance schemes seeking to use capital receipts, which are taxed as income. To the extent that it affects professional trustees, we expect the impact, in terms of competition, to be minimal. The changes will not have any impact upon technological and product developments in the legal profession.

Enforcement, Sanctions and Monitoring

15.49 The provisions being introduced are intended to make it easier for lay trustees to comply with their obligations. Therefore, we think the danger of non-compliance is minimal. We will continue to monitor tax returns and review entries in the usual manner.

15.50 Trustees who receive a taxed income of £1000 a year or less will not usually be required to make a tax return, unless required to do so for CGT purposes or because they have additional income tax to pay. The measures being introduced do not increase the likelihood of non-compliance, and we already have systems in place to monitor and enforce compliance.

15.51 Our current system for monitoring compliance with the tax regime by trustees and other persons connected with trustees is based on selective examination of the Self Assessment returns filed by the trustees of settlements. The examination is based on the degree of risk of a loss of tax to the Exchequer. We believe that this approach will

continue to be appropriate once the changes covered in this Regulatory Impact Analysis come into effect.

15.52 The changes will not impose additional burdens on any other government organisation.

Implementation and Delivery Plan

15.53 Most of the provisions in the Trust Modernisation package will come into effect from 6 April 2006 and we will be amending the return guide for future years as necessary. However, the common residence test will come into effect from 6 April 2007.

15.54 We are continuing work on trust modernisation and intend to introduce further measures at a later date. The deferred measures are as set out at paragraphs 24-26 of this full RIA.

15.55 We are preparing guidance of the changes for staff which will appear on the trusts pages of the HMRC website. We are also preparing guidance for taxpayers and practitioners.

15.56 Annex A contains a detailed implementation plan.

Post-implementation Review

15.57 We will conduct a review of the effectiveness of all the new Trust Modernisation legislation in September 2007 by which time most of the changes will have taken effect and be established as normal practice.

15.58 We will continue our discussions with trustees and other interested parties to ensure the changes are being implemented correctly.

Summary and Recommendation

- Many settlements will benefit from the reduction in administrative burdens.
- There may be a small cost to HMRC for issuing guidance and amending tax returns.
- The overall cost of the Trust Modernisation package is negligible.

15.59 The Trust Modernisation package has been discussed with representative bodies and other interested parties over a period of time, and the package will reduce burdens, particularly those on trustees of small settlements, and deliver consistency in the way income and gains arising under settlements are taxed.

15.60 We are continuing work on Trust Modernisation with a view to introducing further measures intending to benefit settlements in the future.

Annex A - Implementation and Delivery Plan

A.23 The proposals reduce the administrative burdens on the trustees of settlements. In the main they will not impose further obligations on them. Those proposals, which do make a requirement or where the charge to tax will be modified are noted below.

A.24 Guidance and training will be provided for staff on the new measures. We are also preparing guidance for taxpayers and practitioners, amending the existing guidance as necessary. Where appropriate, the Trust and Estate Return and the Return for individuals will be amended together with the accompanying guidance notes.

Sub-fund Elections

A.25 An election form will be introduced to enable trustees of settlements to elect for sub-funds to be treated for tax purposes as if they were separate settlements. The election form will require a declaration by each trustee of the principal settlement that he or she gives consent, a statement that the necessary conditions are satisfied and such other declarations as the Commissioners for HMRC may require, in particular details of the trustees, the trusts, the property comprised in the settlement, the settlors and beneficiaries.

A.26 Where such an election has been made HMRC may require a trustee, beneficiary or settlor of the principal and sub-fund settlements to provide information in order to determine whether the relevant conditions for the election are satisfied.

A.27 Where an election has been made the sub-fund settlement will be subject to the same requirements and obligations for tax purposes as other settlements. In most cases this will mean having to make an annual return of income and gains.

Retention of Character of Income

A.28 The tax return for individuals will be amended for 2006-2007 onwards and associated changes made to the IT systems that support this work. This will enable individuals who are settlors of settlor interested settlements to return income treated as arising to them so that the correct rates of tax are applied to the different types of income. The guidance notes accompanying the return will be amended to reflect these changes.

Single Charging Mechanism

A.29 The Trust and Estate return will be amended for 2006-2007 onwards and associated changes made to the IT systems that support this work. This will ensure that all capital items that are deemed to be income for tax purposes are charged at the special trusts rates. The guidance notes accompanying the return will be amended to reflect these changes.

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REGULATORY IMPACT ASSESSMENT

Trust Modernisation

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 8 March 2006

Introduction

16.1 This is the Regulatory Impact Assessment that considers the costs and benefits of a number of deregulatory and simplification measures on stamp duty land tax.

16.2 The Stamp Duty Land Tax (SDLT) regime was introduced on 1 December 2003. Since then government has received various representations on areas of the legislation that some feel could be clarified, simplified or even repealed.

Purpose and Intended Effect

The Policy Objectives

16.3 Broadly the Government intends to simplify the stamp duty land tax regime without significant loss of revenue or opening up avoidance opportunities in two ways:

6. To clarify the definition of “chargeable consideration” with regards the to stamp duty land tax regime by excluding various definitions where the potential for confusion and over-complication currently exists. Examples include:
 - A gift or bequest where the recipient is required or agrees to pay any inheritance tax or capital gains tax arising on the gift.
 - The payment by a tenant of landlord’s reasonable costs on the grant, variation or termination of a lease.
 - A covenant by an agricultural tenant to transfer his entitlement to Single Farm Payment to the landlord on termination of the tenancy.
7. To tackle three specific areas of concern where the stamp duty land tax legislation has had unintended effects.
 - Leases – complications arise when leases expire but tenancy continues on an agreed basis; there is also a need to simplify the treatment of lease variations and bring the calculation of stamp duty land tax in line with normal business practice.
 - Partnerships – all transfers of property within partnerships are currently subject to the stamp duty land tax regime in order to discourage their formation as a route to stamp duty land tax avoidance. However this unfortunately also catches transactions within ‘genuine’ partnerships who were not intended to be penalised by the legislation.
 - Trusts – as with partnerships, all land transfers within trusts are potentially subject to stamp duty land tax. Again this creates some perceived inconsistencies within the system particularly around sub-funds of trusts.

Consultation

16.4 Through the stamp duty land tax Working Together Steering Group and its sub-groups Government continues to work with all the key stakeholders of stamp duty land

tax. Here stakeholders continually assess the performance of the stamp duty land tax regime, suggest ideas for improvements and evaluate changes that have already been made. Many of these proposed legislative changes are the result of dialogue and consultation with stamp duty land tax stakeholders both directly and through the Working Together Steering Group.

Options

1. Do Nothing

16.5 This would mean that uncertainty would continue with some aspects of the stamp duty land tax legislation. In addition, areas of concern that have been highlighted to Government would continue to be problematic for practitioners and customers. HM Revenue & Customs' customers and their legal advisers might reasonably feel that their more sensible representations were being ignored.

2. Introduce a Package of Legislative Changes

16.6 Government has decided to enact legislative changes to stamp duty land tax where it is prudent to do so. It has therefore put together a package of changes that can be implemented immediately which represent no significant cost to the public finances and do not open up avoidance opportunities. These measures fall into two categories:

- To clarify the definition of “chargeable consideration” through the introduction of a new set of regulations allowed for within the original stamp duty land tax legislation.
- To tackle three specific areas of concern using new provisions in Finance (2) Bill 2006.
 1. Leases – to tackle the complications that arise when leases expire but tenancy continues on an agreed basis, to simplify the treatment of lease variations and to bring the calculation of stamp duty land tax in line with normal business practice.
 2. Partnerships – Government intends to remove the stamp duty land tax on transfers of interests in a partnership, providing that the sole or main activity of the partnership is the carrying on of a trade (other than a property dealing trade) or a profession.
 3. Trusts – Government intends to remove the charge on transfers between sub-funds unless a beneficiary is a party to the transaction.

Risks of Legislative Change

Perceptions 16.7 The overall length of the legislation will increase with these measures. These changes could therefore be perceived in some quarters as adding to the regulatory burden rather than deregulating and simplifying the legislation. Communication with and early involvement of key stakeholders will be essential in securing their buy-in to these measures.

16.8 Some stakeholders will view these measures as not going far enough. There are other deregulatory proposals (in particular process deregulations) which are in discussion that are not possible to enact this year due to legislative and technical

restraints. Again stakeholders will have to be kept fully informed so that these measures can be put in the context of a rolling programme of deregulations.

Unintended Consequences **16.9** In removing or tampering with anti-avoidance measures within the current stamp duty land tax legislation there is the possibility of opening up new areas of potential avoidance or weakening such measures that are already in existence. Each change to the regime must therefore be interrogated fully to expose and deal with any avoidance issues in advance.

Benefits

16.10 HM Revenue and Customs intends to carry out more work on quantifying the benefits and to undertake a review of the figures in standard cost methodology terms.

Clarification of Chargeable Consideration **16.11** The removal of certain areas that currently technically fall under the definition of “chargeable consideration” will generally clarify this area of the stamp duty land tax legislation. This will make the treatment of property transfers more certain and help clear up many ambiguities. Practitioners and customers will be able to be much more confident of whether a particular transaction falls within the stamp duty land tax remit or not.

16.12 These changes will be made through the introduction of a new set of regulations allowed for within the original stamp duty land tax legislation.

Tackling Three Areas of Concern **16.13** The following legislative changes require primary legislation, and the intention is to legislate in Finance (2) Bill 2006.

Leases **16.14** There is uncertainty as to how the rules on ‘successive linked leases’ apply where an agreement for lease is followed by the grant of a lease. The measure will provide that the rules on ‘successive linked leases’ do not apply in these circumstances.

16.15 The rules on variations in rent will be simplified. The current charge on rent increases not provided for in the lease (paragraph 13 of schedule 17A of the Finance Act 2003) will be restricted to increases in the first five years of the lease. All rent increases after the end of year five, whether provided for in the lease or not, will be subject to the ‘abnormal increase’ rules in paragraphs 14 and 15 of schedule 17A. The formula for what is an ‘abnormal increase’ will also be simplified.

16.16 The treatment of rent reviews under the legislation governing agricultural tenancies, and of ‘interim rents’ under the legislation governing business tenancies, will be clarified.

16.17 The treatment of leases which are ‘backdated’ and expressed to commence immediately after the expiry of a former lease, will be simplified and clarified.

16.18 The rules for notifying assignments of leases will be clarified to make it clear that where a lease was originally granted for less than seven years its assignment need be notified only if there is stamp duty land tax to pay, or if there is a relief to be claimed.

Partnerships **16.19** At present there is a charge to stamp duty land tax where there is a transfer of an interest in a partnership, if the partnership property includes land. That charge will be removed for all partnerships whose main activity is the carrying on of a trade (other than a trade of dealing in or developing land) or a profession. This means that most partnerships will no longer even have to consider whether there are any stamp duty

land tax implications due to changes to their partners. This will benefit up to 600,000 partnerships that own or lease land if and when they change their partners.

16.20 There are also two places in the stamp duty land tax legislation in partnerships where there is the possibility of a double charge (the charge on ‘actual consideration’ in paragraph 10 of schedule 15 of the Finance Act 2003 and the interaction between paragraphs 14, 17 and 17A of schedule 15). This potential double charge will be removed.

Trusts 16.21 It is common for one overarching settlement to have several sub-funds, perhaps for different classes of beneficiaries. The stamp duty land tax treatment of transfers of assets between such sub-funds is unclear. These measures will put it beyond doubt that there is no stamp duty land tax charge on such transfers.

Overall Benefits 16.22 The clarification of these areas of the legislation will provide certainty for customers, their property law advisers and government. We expect this to reduce the burden placed on solicitors and conveyancers in respect of these areas of the legislation, and therefore potentially reduce the cost burden placed on customers.

16.23 It will also increase the fairness of the stamp duty land tax system. Areas that were never intended to fall under the current stamp duty land tax regime will be removed and areas of confusion will be clarified. Increased clarity will contribute to a more equitable assessment of stamp duty land tax liabilities.

Costs

Government

16.24 None of these changes will require any amendments to the current array of forms associated with stamp duty land tax. No major process changes will be involved. No additional avoidance of stamp duty land tax is anticipated as a result of these measures.

16.25 HM Revenue & Customs anticipate that these measures will have a negligible overall effect on the amount of revenue the Exchequer receives in the form of stamp duty land tax each year.

Customers

16.26 There should be no additional costs to customers, businesses or their advisers as a result of these measures, and indeed there may be a cost saving, as for many transactions customers and their advisers will no longer have to consider the impact of stamp duty land tax. HM Revenue and Customs intends to carry out more work on quantifying the benefits and in due course will also undertake a review of the figures in standard cost methodology terms.

Sectors and Groups Affected

16.27 All solicitors, conveyancers and legal professionals (and clients thereof) dealing with land transactions affected by the legislative changes outlined will benefit from these changes.

Small Firms Impact Test

Property Law Practitioners

16.28 Property solicitors and conveyancers should find the stamp duty land tax process simpler in the areas addressed by these changes, less time will be needed for some currently unclear or overly complicated areas. As the majority, around 95%, of legal practitioners are small firms these measures will have a disproportionately positive impact on small businesses in the sector affected.

Customers

16.29 These measures will clarify to what situations stamp duty land tax is applicable and therefore make financial planning around property transactions easier for small businesses and individuals. In addition, if property law practitioners choose to pass on the benefits of these measures to their clients then the compliance burden, of affected transactions, will decrease for stamp duty land tax customers.

Competition Assessment

16.30 These changes will have little or no effect on competition within the markets to which they apply, namely the conveyancing and property law professions. The competition filter test has been applied. There are no additional costs to business associated with these changes and they do not affect any firms substantially more than any others. The property law sector is not dominated by a small number of practices and these changes will have little or no effect on the structure of the market.

Enforcement, Sanctions and Monitoring

16.31 Stamp duty land tax has been continually monitored since its introduction in December 2003. As well as feedback through the stamp duty land tax help-line, several surveys have been conducted on practitioners' experiences of the new tax. Close contacts have been maintained throughout with practitioners' representatives and the law societies. These channels of communication will continue beyond the implementation of these changes enabling government to evaluate their effectiveness almost immediately.

16.32 The work of the stamp duty land tax Working Together Steering Group and its sub-groups will continue and thus provide valuable feedback on these changes.

Implementation and Delivery Plan

16.33 The changes to the definitions of chargeable consideration will take effect on 12 April 2006. The measure contained within Finance (2) Bill 2006 will take effect when it receives royal assent.

Post-implementation Review

16.34 The final RIA for Modernising Stamp Duty, published in March 2004, announced a post-implementation review within three years. It was promised that the review would examine compliance costs for business and individuals, solicitors and conveyancers and would review the additional yield and effectiveness of the compliance measures brought in as part of the new stamp duty land tax regime.

16.35 The Government will now include these measures within the scope of that post-implementation review and examine the benefits brought about by these legislative changes.

Summary and Recommendations

16.36 The proposed changes will have a beneficial effect on those legal practitioners that deal with the areas affected by these measures and their clients. There will be no additional costs to customers or the Exchequer while the risks that exist are manageable by Government. HM Revenue & Customs therefore proposes that these legislative changes be implemented.

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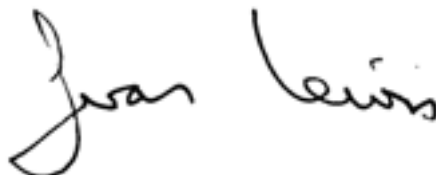
REGULATORY IMPACT ASSESSMENT

Deregulation and Simplification on Stamp Duty Land Tax

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Ivan Lewis
Economic Secretary to the Treasury

Dated: 13 March 2006

RIA FOR ALIGNMENT OF MACHINE DEFINITIONS AND REMOVE NON-GAMING MACHINES FOR AMLD

ALIGNMENT OF MACHINE DEFINITIONS TO CORRESPOND WITH VAT AND SOCIAL LEGISLATION AND THE REMOVAL OF NON-GAMING MACHINES FROM THE AMUSEMENT MACHINE LICENSE DUTY REGIME

Introduction

17.1 Alignment of machine definitions to correspond with VAT and social legislation and the removal of non-gaming machines from the amusement machine licence duty regime.

Purpose and Intended Effects of the Measure

The Policy Objectives

17.2 Tax definitions of a gaming machine have traditionally followed social definitions. The Gambling Act has updated social definitions, inter alia, to keep pace with technological developments that had allowed some machines to fall outside the definition of a gaming machine.

17.3 The definition of a 'gaming machine' in VAT law was changed by Treasury Order, with effect from the 6th December 2005, to reflect the updated social definition. The new definition of a 'gaming machine' in VAT law was based on the definition contained in s235 of the Gambling Act 2005 (although that has not yet been brought into force). It ensures that all gaming machines are within the scope of VAT, protecting VAT revenues for the future.

17.4 The Finance Bill will now make a similar change to the definition of a gaming machine in excise law. Excise law will be aligned with VAT and social legislation, taking effect from 1 August 2006. This will affect two broad categories of machine: fixed odds betting terminals (FOBTs), located in licenced bookmakers, and machines licenced under Section 16 of the Lotteries and Amusements Act 1976 and Section 21 of the Gaming Act 1968 (16/21s), located in arcades, bingo halls and casinos. These machines will clearly fall within the revised definition of a gaming machine and be subject to amusement machine licence duty (AMLD).

17.5 The Finance Bill will also align the amusement machine licence duty categories with those that will be introduced by s236 of the Gambling Act 2005 (although the Secretary of State for DCMS has not yet made the necessary regulations some of the new entitlements under these categories have been given an early introduction). This will take effect from 1st August 2006 and will be a regulatory simplification that ensures excise law remains appropriate in a changing machine environment. Aligning machine categories with social law will also benefit the industry by removing the requirement to account for amusement machine licence duty on non-gaming machines.

17.6 These changes apply to the whole of the UK.

Consultation

Public Consultation

17.7 Although the PBR is the only formal consultation on the alignment of machine definitions to correspond with VAT and social law that has been conducted, we have been in close dialogue with the industry's trade bodies to discuss various aspects of this change. The industry was generally receptive and agreed that our intention to align the amusement machine licence duty regime with the Gambling Act was desirable.

17.8 The last formal consultation on the details of Amusement Machine Licence Duty was In July 2003 when the Government published the consultation document, 'Modernisation of the Gambling Taxes: Review of Amusement Machine Licence Duty'. The consultation ended in October 2003 and a summary of the results was published in the same month. Businesses, suppliers, trade associations and others with an interest were encouraged to provide information and their views about any potential reform to amusement machine licence duty.

17.9 The summary of results shows that a number of responses to this consultation recommended the removal of the requirement to account for amusement machine licence duty on non-gaming machines. This is one of the changes included in this measure.

Consultation with Government

17.10 We have been in close dialogue with officials at the Department of Culture, Media and Sport on aligning with the Gambling Act.

Options

1. Do Nothing

17.11 This would put revenue at risk and leave the tax and regulatory benefits of these changes unrealised.

2. Alignment of the Definition

17.12 Alignment of the definition of a gaming machine to correspond with the VAT Order 2005 and section 235 of the Gambling Act.

3. Alignment of Machine Categories

17.13 Alignment of machine categories to correspond with those that will be introduced by s236 of the Gambling Act and set rates.

4. Options 2 and 3 Combined

17.14 Both of the above options, 2 and 3, as set out by the Finance Bill.

Costs and Benefits

17.15 The change to the excise definition of a gaming machine imposes an extra compliance cost on premises that operate either FOBTs¹ (licensed betting offices) or 16/21s (bingo halls, casinos and arcades).

17.16 It is assumed that all 8,600 betting offices will have to complete an additional AMLD application form to licence their FOBTs. Based on the assumption that managers or account clerks take ½ an hour to complete the form, we have estimated an extra regulatory cost to all bookmakers of around £55,000. This is only a few pounds per shop.

17.17 We estimate that of the 8,600 betting offices, around 10% already account for AMLD on other machines. For these businesses the regulatory cost associated with changing the definition of a gaming machine will be a one off cost. In the future, aided by the simplifications we will be making in the summer to the surrender and amendment of licences, these premises will account for the AMLD on all of their machines on the one form.

17.18 Similarly, the approximately 2,600 arcades, casino and bingo halls will have to complete an additional AMLD application form to licence their 16/21 machines. Based on the same assumptions about completion of the form we estimate an extra regulatory cost of approximately £20,000. Similarly, this amounts to only a few pounds per premises and as above the extra regulatory cost associated with changing the definition of a gaming machines will be one off.

17.19 Regulatory costs from the alignment of amusement machine licence duty categories with social law will be minimal. However, the industry will benefit from the removal of the requirement to account for amusement machine licence duty on non-gaming machines. If premises have a combination of machines, then we assume that there will only be a minimal reduction in the regulatory burden, since such premises will still have to licence their other machines. We calculate, based on the length of time taken to complete an AMLD application and on the estimate that there are around 2,700 to 2,800 premises that operate only non-gaming machines, that this measure will decrease the regulatory burden for industry by approximately £25,000.

Small Firms Impact Test

17.20 Minimal effect on small business. There are 665 small bookmakers (operating between 1-15 premises each) occupying 1212 premises in total. It is assumed that the management of small bookmakers complete duty registration in-house. Based on this assumption, we calculate that bringing FOBTs into the AMLD net will increase the cost of regulation to small bookmakers by approximately £12,500. This represents a minimal cost around £10 per premises.

17.21 This cost will be partly offset by the end of the requirement to account for General Betting Duty on a FOBT. In addition, there are approximately 500 to 800 small bookmaking premises that belong to bookmakers who are below the VAT threshold. For each of these premises there is a saving of around £50 per FOBT as a result of replacing General Betting Duty with a requirement to account for AMLD.

17.22 Many of the firms operating section 16/21 machines are small business in the arcade sector. As explained in section 5 these businesses will experience a one of

¹ The Finance Bill will remove FOBTs from the requirement to pay General Betting Duty on their gross profits, with retrospective effect back to 6th December 2005, the date at which they become liable to VAT as a gaming machine.

regulatory cost resulting from the change to the definition of a gaming machine. It will be a minimal amount per premise and total around £12,000.

17.23 There will be very few small businesses that will offer only non-gaming machines, and so the regulatory regulatory savings from removing the requirement to account for AMLD on these machines is small. Most of the 2,750 premises referred to in the last paragraph of section 5 are in the pub sector, and only some will be in small businesses.

Competition Assessment

17.24 Competition filter has been applied. The Government does not believe that this reform will have a significant impact upon competition.

Enforcement, Sanctions and Monitoring

17.25 Through HMRC's usual procedures.

Implementation and Delivery Plan

17.26 Guidance on the measure will be made available on Budget Day.

Post-implementation Plan

17.27 A review of the effects of this measure will be conducted 1 – 2 years after implementation.

Summary and Recommendation

17.28 To align machine definitions, including the definition of a gaming machine and machine categories, with both VAT and social legislation.

17.29 These changes will take effect from 1st August 2006.

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REGULATORY IMPACT ASSESSMENT

Alignment of Machine Definitions to Correspond with VAT and Social Legislation and the Removal of Non-Gaming Machines from the Amusement Machine License Duty (AMLD) Regime

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

A handwritten signature in black ink, appearing to read 'John Healey', written over a light grey background.

John Healey
Financial Secretary to the Treasury

Dated: 16 March 2006

Purpose and Intended Effect of Measure

The Policy Objectives

18.1 The Government announced in the Pre-Budget Report a package of measures to refresh the Tackling Tobacco Strategy. The introduction of this legislation is one of those measures aimed at reducing the availability of genuine tobacco products to smugglers.

18.2 The combination of measures will contribute towards HMRC's PSA target of reducing the illicit market share of cigarettes to no more than 13%, and reducing the illicit hand-rolling tobacco (HRT) market by 1,200 tonnes (around 20%) by 2007/08. The measures will contribute to the reduction of the tax gap and ensure that the relevant duties and taxes due on those products reach the Exchequer.

18.3 The legislation is designed to complement the Memorandum of Understanding (MoU) that HMRC have entered into with a number of leading UK tobacco manufacturers, and ensure that those manufacturers who support HMRC in their efforts to combat tobacco smuggling by doing so are not unfairly disadvantaged. Obligations will therefore be imposed on all tobacco manufacturers to control their supplies to non-UK markets, and ensure, as far as reasonably practicable that they do not facilitate smuggling.

18.4 Tobacco smuggling undermines the Government's policy of using taxation levels as part of its strategy to reduce the incidence of smoking in the UK population. By imposing requirements on tobacco manufacturers to control their supply chains and therefore making it difficult for criminal gangs to obtain large volumes of genuine product, the introduction of this scheme will support the Government's health policy.

Background

18.5 Tobacco smuggling is a major contributory factor to the tax gap. HMRC figures show that:

- £2.9 billion in revenue is currently being lost each year
- Figures for 2003-04 show that 16% of cigarettes and 55% of HRT consumed in the UK were smuggled

18.6 Existing legislation in this area is a combination of EC Directives and domestic law. Within this legislation there are currently no requirements on tobacco manufacturers to consider the risks of potentially facilitating smuggling when supplying product to customers in non-UK markets, or to the markets generally in which they trade. There is similarly no duty to control the volume or mix of brands a tobacco manufacturer supplies to a particular customer or market, to ensure that they are appropriate to the genuine demand for those products.

18.7 This has led to a situation where the volume of tobacco products entering certain markets outside the UK is significantly greater than the estimated total consumption of tobacco products in those countries and the demand of legitimate

cross border shoppers. HMRC believe that the excess product is purchased by criminal gangs for the express purpose of smuggling it into the UK.

Rationale for Government Intervention

18.8 A number of leading UK tobacco manufacturers, supported by the Tobacco Manufacturers Association (TMA) have been active in working with HMRC to tackle the problem of tobacco smuggling. The ensuing dialogue has resulted in the manufacturers involved entering into MoUs with HMRC, which set out a framework of cooperation aimed at the shared objective of limiting the smuggling of both contraband and counterfeit product into the UK.

18.9 These agreements are an important step towards dealing with the problem of tobacco smuggling, and are representative of the co-operation of the manufactures involved. However the MoUs are voluntary agreements and only apply to the signatory manufacturers. By introducing legislation to complement and support the MoUs, all tobacco manufacturers are placed under the same obligations and they risk a penalty being imposed by HMRC for the breach of those obligations

Consultation

Within Government

18.10 Enquiries were made with the Home Office, Department for Trade and Industry, and the Department for Constitutional Affairs (DCA). The main stakeholder is the DCA, which will have to make provision for extra VAT and Duties Tribunals. They are currently content that the impact in this area will not be significant; neither of the other departments believed they would be significantly affected by the proposals.

18.11 Contact has also been made with The Scottish Executive, The Northern Ireland Office, and Customs and Excise in the Isle of Man as the legislation is intended to apply across the UK. Additionally because the scheme impacts on manufacturers outside the UK, approaches were made to the European Commission. An outline of the scheme was provided, and again HMRC have not received any expression of concern, or comments from those that were approached.

Public Consultation

18.12 The measure was originally announced in December 2005 as part of the Pre Budget Report. A discussion document was issued to the tobacco manufacturers during January 2006, following which meetings were held with a number of tobacco manufacturers and the Tobacco Manufacturers Association (TMA).

18.13 A joint response was received from the TMA on behalf of its members, and also from one other tobacco manufacturer. Following these representations the detail of the scheme was revised to incorporate as far as possible the legitimate views and concerns of the respondents.

18.14 The legislation impacts only upon tobacco manufacturers; as such it was not considered appropriate to extend the consultation further.

Options

18.15 During 2005 discussions were held within HMRC regarding the volume of genuine tobacco products reaching organised criminal gangs in commercially viable quantities. This resulted in the identification of a number of possible options to address the issue. However, on further analysis, all but one of these options was discounted on various grounds including effectiveness, compatibility with other legislation, complexity, and cost.

1. Do Nothing

18.16 If we do not take action, organised criminal gangs will continue to exploit weaknesses in supply chains and be able to source genuine tobacco products in commercial quantities. Revenue will continue to be lost, public health initiatives undermined, and retailers of UK duty paid product disadvantaged. Profits from the illegal activity will continue to accrue, and may be used to fund other illegal activities with consequential implications, both financial and social.

2. Introduce Legislation Complementary to the Existing MOUs

18.17 The legislation will impose duties on all tobacco manufacturers to assess and address the risks involved in selling their product. Firstly manufacturers will be required to maintain a written policy that specifies the actions they will take to ensure that their supply chains, and where practicable the supply chains of their customers are as secure as is reasonably possible. Secondly the legislation will require them to sell their products in quantities that are commensurate with the consumption of their product in the destination country and any additional demand from legitimate cross border shopping. Thirdly they will be required to furnish to HMRC information relating to the markets in which they operate, and any product seized by HMRC in order that HMRC can assess the effectiveness of their policies, controls and actions.

18.18 The legislation is framed so as to mirror the main obligations of the MOUs, and in so doing extend those obligations to all manufacturers. Where manufacturers did not comply with these duties the legislation would allow for the raising of a financial penalty.

Costs and Benefits

Sectors and Groups Affected

18.19 The only businesses that will be directly affected by the introduction of the new legislation are tobacco manufacturers.

18.20 Retailers of UK duty paid tobacco products may indirectly benefit from a reduction in the amount of genuine tobacco product on the UK illicit market, resulting from the requirements being imposed on tobacco manufacturers to control their supply chains, and the increased difficulty smugglers will face sourcing genuine cigarettes and HRT.

18.21 The proposal will have no race, Human Rights, Northern Ireland or other equality impacts.

Benefits

1. Do Nothing

18.22 The MoUs currently in place with leading UK tobacco manufacturers should contribute to reducing the availability of genuine product to smugglers. However, the MoUs are voluntary agreements and are limited to those signatories who have agreed to cooperate with HMRC. There is also no recourse if a tobacco manufacturer chooses to opt out of, or selectively adheres to the terms of the MoU.

18.23 By doing nothing, and failing to require other manufacturers to control their supply, HMRC risks undermining the agreements and the commitment they represent. Organised criminal gangs will continue to exploit weaknesses in supply chains where manufacturers do not have MoUs or similarly extensive control policies. There is therefore no benefit to inaction.

2. Introduce Legislation Complementary to the Existing MOUs

18.24 By introducing legislation HMRC can extend the potential benefits to be gained from the MoUs to all manufacturers. This would prevent the MoUs being undermined, and place comparable responsibilities on all tobacco manufacturers, not just those who have voluntarily undertaken to work with HMRC. Creating a legal duty on all tobacco manufacturers to have effective controls over their supply chains avoids displacing the issue to other manufacturers.

18.25 The scheme is designed to encourage the exchange of information between HMRC and tobacco manufacturers, providing for a greater understanding of the size of the market and the nature of the smuggling risks, whilst also notifying tobacco manufacturers of potential weakness in their supply chains through details of material seizures.

18.26 If a tobacco manufacturer does not comply with the obligations imposed, the scheme enables HMRC to issue substantial penalties to encourage compliance with the scheme, and ensure other tobacco manufacturers who do comply are not disadvantaged.

18.27 By reducing the availability of genuine tobacco products to smugglers the scheme, along with other measures announced as part of the strategy, will help to disrupt the activities of organised criminal gangs and thus impact on the profits available to fund other illegal activity, with consequential financial and social benefits.

18.28 By disrupting supplies of genuine product to organised criminal gangs, the scheme will help to reduce the availability of smuggled genuine product available in the UK. This will have consequential benefits for retailers of UK duty paid tobacco products, whose businesses are detrimentally affected by the illicit trade.

Costs

To Tobacco Manufacturers

18.29 The legislation is deliberately designed to mirror the MoU working arrangements already agreed with leading UK tobacco manufacturers; as such any additional costs to those manufacturers should be minimal. For example, the

examination, testing and tracing of product from significant seizures have cost implications, but these activities have, for some time been carried out by a number of tobacco manufacturers on a voluntary basis.

18.30 In meetings with HMRC the tobacco manufacturers indicated that there might be some additional costs arising from the legislation. For example, some expressed their intention to physically inspect all material seizures, as they would be entitled under the legislation. This would have some consequential costs, which the tobacco manufacturers have not yet quantified in their written responses to the discussion document.

18.31 In other circumstances, where tobacco manufacturers follow good business practice in terms of whom they deal with and how they regulate such relationships, the legislation will impose minimal additional costs – e.g. tobacco manufacturers will incur the costs associated with setting up and maintaining a supply policy, if they do not already have one. Further costs will only be incurred if significant quantities of genuine products are seized from smugglers who have been able to source large quantities of a tobacco manufacturer's product. Overall, HMRC believe that any costs incurred are likely to be proportionate to the objectives and benefits of the scheme.

To HM Revenue and Customs

18.32 Administration of the scheme will be managed from within existing resources and procedurally through the adaptation of existing systems.

18.33 There will be some additional storage requirements at the Queens Warehouse in relation to holding seizures under the scheme, which will carry some cost, as will facilitating the inspection of seizures by manufacturers. However, there is sufficient extra capacity currently available and this will be monitored along with the impact of the full package of measures.

Small Firms Impact Test

18.34 The scheme applies to all tobacco manufacturers regardless of size, in that they must have a supply policy, and this policy would be a factor in any penalty issued under the scheme. However, in the main, tobacco manufacturers are multi-national corporations, and the size of the seizure threshold makes it very unlikely that HMRC would make a material seizure, or repeated material seizures of product from the limited number of smaller manufacturers.

Competition Assessment

18.35 The legislation addresses the illicit trade in cigarettes and hand-rolling tobacco, and places no restriction on bona fide transactions. As such tobacco manufacturers will not be at a competitive disadvantage in any genuine market in which they operate.

18.36 It is the opinion of HMRC that none of the options considered bring about any competition issues for tobacco manufacturers.

Enforcements, Sanctions and Monitoring

18.37 The legislation will impose specific obligations on tobacco manufacturers, namely to take reasonably practicable steps to prevent their tobacco products leaving

the legitimate supply chains, and becoming available to organised criminal gangs in commercial quantities for the purpose of smuggling.

18.38 HMRC will assure compliance with the terms of the scheme and the MOUs through their risk and assurance programmes, monitoring levels of seizures and notifying the trade of any material seizures as required. The scheme provides for an open and continual dialogue with the tobacco manufacturers regarding their actions, and the measures undertaken to address issues of supply chain control, which will facilitate the monitoring and enforcement of the scheme.

18.39 The scheme permits a sanction of up to £5,000,000 for those manufacturers who fail to comply with the responsibilities placed upon them.

Implementation and Delivery Plan

18.40 The measure will be introduced by Finance Bill 2006 and will be implemented in Autumn 2006. Existing teams within HMRC who already have well-established links with tobacco manufacturers will deliver the scheme.

Post-implementation Plan

18.41 The operation of the scheme and its impact upon tobacco smuggling will be monitored by HMRC as part of an ongoing process of review and assessment.

Summary and Recommendation

18.42 The measure affects a small number of predominantly large businesses both in the UK and abroad, and for those already following good business practice in the areas concerned, it should have very little discernible impact.

18.43 Whilst some tobacco manufacturers and the TMA have mentioned in meetings with HMRC that there may be some additional costs relating to the scheme, these have not yet been quantified. However, any costs incurred are likely to be proportionate to the objectives and benefits of the scheme.

18.44 The scheme is fit for the purpose for which it was designed with minimal regulatory impact and it is recommended for acceptance.

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REGULATORY IMPACT ASSESSMENT
Tobacco Duty: Control of Supply Chains
Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

A handwritten signature in black ink, appearing to read 'John Healey', written over a light grey horizontal line.

John Healey
Financial Secretary to the Treasury

Dated: 16 March 2006

REGULATORY IMPACT ASSESSMENT FOR LEASED PLANT AND MACHINERY (LEASING REFORM)

Introduction

19.1 This final Regulatory Impact Assessment updates the partial RIA published on 5 December 2005.

19.2 In the 2004 Pre Budget Report it was announced that:

- the tax treatment of leased plant and machinery would be reformed; and
- legislation on these proposals would be included in Finance Bill 2006.

19.3 Technical Notes that set out details of the new regime were published on 4 December 2004, 21 July 2005 and 5 December 2005. The Technical Notes and this Regulatory Impact Assessment are available at <http://www.hmrc.gov.uk/leasing/>.

Purpose and Intended Effect of Measure

The Policy Objectives

19.4 The current tax rules treat loan finance and leasing finance differently even though the commercial effect – that the business uses the asset while another party finances its purchase – may be virtually the same. This difference in treatment, particularly the incidence of tax timing benefits that can be afforded by capital allowances, means that in some cases commercial decisions can be affected by the tax treatment of the transaction.

19.5 The objective of the proposal is that where leases function as financing transactions, and commercial decisions are affected by the tax treatment, they will be taxed in a similar way to loans.

19.6 Generally accepted accounting practice (GAAP) classifies leases as finance leases or operating leases. Finance leases are leases that transfer substantially all the risks and rewards of ownership to the lessee and by their nature function as financing transactions. However, some operating leases also function as financing transactions and these need to be identified if the policy objective of applying the new regime to leases that function as financing transactions is to be met.

19.7 Not all leases that function as financing transactions carry a tax benefit that is likely to affect commercial decisions. In particular this is the case for shorter financing transactions and so shorter leases will be excluded from the new regime. These shorter leases comprise the great majority of leases by number and excluding them will minimise the impact on business.

19.8 The policy objective of taxing leases that function as financing transactions in a similar way to loans will be achieved by taxing lessors and lessees on the basis of the substance of the transaction. Lessors will be taxed similarly to the way they would be had they made a loan and lessees, the economic owners, will be treated as though they had acquired the asset and be able to claim capital allowances.

19.9 Leasing reform will allow the Government to remove current restrictions on overseas leasing in sections 109 and 110 Capital Allowances Act 2001 and relax the rules for allocating expenditure when an asset is acquired for finance leasing. These revised

rules will however apply to a wider range of transactions than before, as described below.

Background

19.10 The new regime will apply to leases of plant and machinery and to similar transactions that are properly accounted for as leases under GAAP.

19.11 As mentioned above, GAAP recognises two types of lease: finance leases and operating leases. In practice, leases of plant and machinery exhibit a range of characteristics that place them on a spectrum from pure financing transactions to short term operating leases. Consequently some leases that are classified as operating leases for accounting purposes are essentially financing transactions.

19.12 The reform introduces a statutory definition to identify leases that function primarily as financing transactions. This definition covers all finance leases and a small proportion of leases that, although correctly accounted for as operating leases, are essentially financing transactions. The leases covered by the definition are referred to as ‘funding leases’. There will also be rules that exclude shorter leases and so the new regime will only apply to ‘long funding leases’.

19.13 The tax timing advantage of capital allowances is usually small or non-existent for shorter leases and does not affect the decision to lease an asset rather than finance it via another route. Therefore new regime will not apply to:

- leases of 5 years or less; and
- leases of between 5 and 7 years where, on an annual basis, the lease rentals do not vary by more than 5% (after excluding variations linked to changes in interest rates and exceptional payments made at or before inception) and the residual value implied by the lease terms is no more than 5% of the fair value of the asset at the start of the lease.

19.14 A hire purchase transaction is a type of lease. Hire purchase transactions with lessees carrying on a qualifying activity (such as a trade¹) will not be affected by the reform. However, at present, the tax treatment of lessors depends on whether the activity is within the charge to corporation tax or income tax: a trade, for example, is not a qualifying activity if it is not within the charge to tax (for example because it is carried on abroad).

19.15 Therefore it is proposed the tax treatment of lessors entering into hire purchase transactions with a lessee that would be carrying on a qualifying activity were they within the charge to tax will be brought into line with the tax treatment where the lessee is within the charge to tax.

19.16 There will also be two changes to the rule for allocating expenditure to chargeable periods when an asset is acquired for finance leasing (section 220 Capital Allowances Act 2001):

- currently the amount of capital allowances available to a finance lessor in the period in which the leased asset is acquired is restricted to expenditure

¹ Section 15 Capital Allowances Act 2001 defines a qualifying activity as “a trade, an ordinary Schedule A business, a furnished holiday lettings business, an overseas property business, a profession or vocation, a concern listed in section 55(2) of ICTA (mines, transport undertakings etc.), the management of an investment company, special leasing of plant or machinery, and an employment or office, but only to the extent that the profits of gains from the activity are, or (if there were any) would be, chargeable to tax.” In this context ‘tax’ means corporation tax or income tax.

that is proportional to the part of the chargeable period for which the asset is held. This rule will be relaxed so that it only applies where the lessor does not use the group's normal accounting date; and

- currently these rules only apply to finance leases. From 1 April 2006 where the lease term is for more than 4 years the rules in section 220 will also apply to operating leases that are funding leases.

19.17 The second of these changes arises from changes to the provisions relating to the exclusion of shorter leases. Consultation responses indicated that policy objectives would be better served by excluding all leases of less than 5 years, and excluding leases of 5 to 7 years where certain conditions are met. Extending the scope of section 220 will ensure that this wider exclusion will not have a distortionary effect.

19.18 Although the reform will apply to a significant number of leases, typically with a high value, most leases will be excluded from the new regime by virtue of either:

- the definition of funding leases; or
- the rule to exempt shorter leases, potentially of up to 7 years.

19.19 The taxation of long funding leases will be dependent on their correct accounting treatment. Where a lease is a long funding lease:

- finance lessors will be taxed on the finance income recognised in their accounts, rather than on their gross rental receipts. In computing their taxable profits, finance lessees will be allowed to deduct the finance cost elements of rental payments as shown in their accounts. Capital allowances will be available to lessees rather than to lessors; and
- operating lessors and lessees will be taxed, in principle, in a similar way to finance lessors and lessees, though the detailed mechanism is different. As with finance leases, capital allowances will be available to lessees rather than to lessors.

19.20 In the absence of further measures the new regime might allow capital allowances to be claimed more than once in respect of what is essentially the same expenditure. Therefore the new regime will prevent a long funding lessee from claiming capital allowances if the lessor or any superior lessor (if there is one) is entitled to claim capital allowances.

19.21 A lessee who views a lease as a long funding lease and wishes to claim capital allowances will need to establish whether or not the lessor (or any superior lessor) is entitled to claim capital allowances. That is,

- if, as will normally be the case, the lessee establishes that lessor (or any superior lessor) is not entitled to capital allowances the lessee will be able to do so; and
- if, exceptionally, the lessee establishes that the lessor (or any superior lessor) is entitled to capital allowances the lease will be treated as a non-funding lease.

19.22 Where, exceptionally, a lessor (or any superior lessor) is not within the charge to corporation tax or income tax, then similar concepts will apply. The lessee will need to establish whether the lessor (or any superior lessor) would be entitled to capital allowances if within the charge to corporation tax or income tax.

19.23 In practice we anticipate that any necessary information will be made available to the lessee as a standard part of the lease documentation.

19.24 If the lessee cannot establish whether the lessor (or any superior lessor) is entitled to claim (or not entitled to claim) capital allowances, or chooses not to claim capital allowances, the lease will be treated as though it were not a long funding lease and be taxed under the existing rules.

Rationale for Government Intervention

19.25 It is economically undesirable for the tax system to affect the decision between lease finance and loan finance. The new regime will reduce the scope for tax considerations to influence the choice between different types of finance.

Consultation

Consultation within Government

19.26 HM Treasury, the Department of Trade and Industry, the Department for Transport and Small Business Service have been involved. There has also been wide consultation within HMRC including policy, operational and technical teams.

Public Consultation

19.27 Following the publication of the August 2003 consultation document on the Reform of Corporation Tax, a series of consultation meetings was held. More than 50 representatives of business attended these meetings. Additional meetings were held with particular business sectors and industry representatives with a special interest in leasing and in the effect of reform on lessors and lessees.

19.28 There were 148 written responses to the August 2003 consultation document. Many of those that referred to the proposed leasing reforms have engaged in further informal discussion and facilitated an understanding of the practical and technical aspects of the policy development.

19.29 The Government welcomed the comments and used them to develop the regime proposed in the December 2004 Technical Note. Following the publication of the December 2004 Technical Note, a further series of consultation meetings was held with particular business sectors and industry representatives with a special interest in leasing and in the effect of reform on lessors and lessees. These consultation meetings continued after the formal consultation period ended in February 2005.

19.30 There were over 80 written responses to the December 2004 Technical Note. Many of those that responded engaged in further informal discussion. These discussions have been very constructive and facilitated an understanding of the practical and technical aspects of the policy development.

19.31 Further Technical Notes were published in July and December 2005 covering, in particular, the commencement and transitional rules, a refined definition of a plant or machinery lease, a refined definition of long funding leases (including the exclusion for shorter leases), and an exclusion for plant and machinery leased with property. There were over 60 responses to these Technical Notes. Several respondents have engaged in informal and constructive discussions that continue to facilitate the development of the new leasing regime.

19.32 The Government has welcomed the comments that it has received from business during the periods of consultation.

Options

1. Do Nothing

19.33 One option would be to leave the current tax treatment of leases that essentially function as financing transactions unchanged. But this would not achieve the objective of reducing the influence of the tax system on different forms of finance.

2. Capital Allowances to lie with the Lessee

19.34 Therefore the chosen option is to provide for the right to capital allowances to lie with the lessee where leases are long funding leases. Corresponding adjustments will be made to the taxable and deductible amounts of the rental payments – the interest elements in rental payments will be taxable on the lessor and deductible for the lessee, rather than the full rental payments. Broadly the effect will be that the lessor and lessee will be taxed as if the transaction had been a loan from the lessor to the lessee, with which the lessee had bought the asset.

19.35 Under the proposal, leases will be taxed in one of the following ways:

- the current regime will remain for most leases. The lessor will get capital allowances and will be taxed on the gross rentals, and the lessee will deduct gross rentals; or
 - where leases are long funding leases the lessee will get capital allowances; and
8. where the lease is accounted for as a finance lease the lessor will be taxed on, and the lessee will deduct, the interest element of rentals shown in the accounts; but
 9. where the lease is accounted for as an operating lease the lessor will be taxed on, and the lessee will deduct, the gross rentals less the difference between the initial value and the estimated residual value of the asset, all on a straight-line basis.

Election

19.36 Companies will be able to elect for leases, other than leases of cars, that would otherwise fall outside the new regime to be treated as if they were within the new regime.

19.37 Where a company's accounts are an accurate approximation of the result that would be achieved on electing into the new regime then, subject to reaching agreement with HM Revenue & Customs, the company will be able to base its taxable profits on the profits shown by the accounts.

19.38 This option will decrease compliance costs and will be deregulatory because there would no longer be a need to make capital allowance claims and keep track of assets where a short life asset election had been made. It will also remove a distortion whereby lessors of short-lived assets suffer a tax-timing disadvantage.

Costs and Benefits

Business Sectors Affected

19.39 HM Revenue & Customs has estimated that the total effect on investment in the UK economy will be to reduce investment by 0.07%: £80m pa of the total annual business investment of £110bn.

19.40 This modest reduction in investment arises mainly from the fact that some businesses, which have tax losses, will no longer be able to use long funding leases as a means of reducing their cost of capital. While businesses in any sector can be non-taxpaying because of losses, some sectors may be more prone to cycles with loss-making phases than others.

19.41 As the focus of the reform is on longer leases, SMEs will not be among those affected, except in unusual circumstances. This is because the vast majority of leases to SMEs will be outside the new regime.

19.42 Non-funding leases will be not affected by the proposal, and those longer funding leases that are affected could still be written, as the proposed new regime will tax them on the basis of their commercial substance.

19.43 Long funding lessees will benefit from capital allowances.

19.44 Some sectors that will be affected more than others are identified below but in no case will the increase in funding cost be more than about 1 to 1.5% compared with leasing under the current regime.

Green Technology

19.45 There is no evidence of a substantial amount of leasing of green technology.

19.46 Continuing to allow lessors of all green technology to claim enhanced capital allowances risked making the new regime unstable. Therefore the Government has decided to withdraw enhanced capital allowances from lessors, except where the leased asset is a low CO2 emission car or green technology leased as part of the lease of a building.

Shipping and Tonnage Tax

19.47 Tonnage tax companies do not get capital allowances, but they can still benefit from them indirectly, by way of reduced rentals, when they lease ships. Without further action, the reform would impact on shipping companies that had elected for tonnage tax.

19.48 Subject to certain conditions lessors will remain taxable under the existing regime where they lease qualifying ships directly, and in some cases indirectly, to a tonnage tax company.

19.49 To qualify for this exemption from the scope of leasing reform, the tonnage tax company, in addition to having strategic and commercial management of the ship in the UK, must be responsible for the operation of the ship and the ship must not be chartered out (leased out) for a period of more than 7 years.

PFI and Local Authorities

19.50 PFI projects often involve non-taxpaying end users and many contracts are constructed as composite trades where capital allowances are not in point. Furthermore very few PFI projects enter into leasing arrangements, or other transactions that are accounted for as leases. As such all, or almost all, PFI projects will

be outside the scope of the reform. Any that are affected will see only a very modest impact.

Rail 19.51 The Government understands that in the short term there should be little or no effect on leases of passenger rolling stock if they continue to be written on the terms that are currently common.

Air 19.52 Not all aircraft are financed by UK lessors and airlines already make extensive use of non-UK providers of finance which means that there will be some impact on airlines' costs of obtaining aircraft, the Government believes this will not be significant.

Oil and Gas 19.53 Minor consequential changes will be made to the rules on sale and leaseback of assets used in a ring fence trade and to the deductibility of financing costs in computing the supplementary charge on ring fence profits.

Manufacturing 19.54 There will be no significant impact on manufacturing. Any impact is likely to be limited to firms with tax losses persisting over several years, where they may be a small increase in cost of capital – but only if they choose to use leasing to finance new plant and machinery with relatively long life (i.e. typically heavy plant).

Property 19.55 Buildings such as offices and retail premises generally include items of plant or machinery such as central heating, air conditioning and lighting. In general, leases of such property are not financing transactions and the leasing of the plant or machinery within such property is incidental to the lease of the property itself.

19.56 The Government has accepted that it would not be appropriate to bring leases of such plant and machinery within the scope of the new regime. Therefore the new regime will not normally apply where plant or machinery is leased as an incidental part of a typical property lease.

19.57 The type of plant or machinery that will be excluded is that which is incidental to the occupation of the building, such as electrical, heating and air conditioning systems. However, the exemption will not be defined by reference to type of building and so it will extend to similar plant or machinery, in whatever type of building or structure it may be found.

Benefits

19.58 The benefits from this measure will be that:

- it will remove an influence of the tax system on the choice between a loan and a lease that is essentially a financing transaction. It will allow the choice to be made on commercial grounds such as the level of security for the financing;
- the special rules for cross border leases will no longer be needed, which will facilitate the development of overseas leasing; and
- the scope of the allocation rule will be changed (paragraph 19.16 above) and this should reduce administrative and compliance costs and be a significant simplification for business.

19.59 If a company elects into the new regime and produces accounts that approximate the effect of the new regime there would be a saving in compliance costs for some lessors because the need to produce capital allowance computations would be reduced.

Costs

19.60 In assessing the costs and benefits, it is noted that the following will be unaffected:

- leases (of any type) entered into before 1 April 2006;
- leases within the transitional rules;
- most operating leases; and
- shorter funding leases excluded from the proposals.

19.61 Together these categories account for the vast majority of leases written by the asset finance and leasing industry.

Costs for a typical business

19.62 The changes are likely to affect a small proportion of leases. These are mainly leases of large assets for long periods. The effect of these changes is that the transactions will either be taxed on the basis of the accounts or require relatively straightforward adjustments.

19.63 Where leases are affected it should usually be very straightforward to determine the category of a lease for tax purposes.

19.64 Where a lease is affected by the new regime lessors will need to establish a mechanism whereby they can inform lessees whether they (the lessors) are entitled to claim capital allowances (or would be if within the charge to corporation tax or income tax).

19.65 Where a lessee does not want to come within the new regime (and so claim capital allowances) there will be no change from the present situation. It is anticipated that this will be the case with the vast majority of lessees.

19.66 Where a lessee wishes to come within the new regime it will be treated in a way that, in most cases, is similar to the way in which hire purchase transactions are taxed under the current regime. Lessees will, however, need to determine whether or not they are prevented from coming within the new regime by the lessor (or a superior lessor) being entitled to claim capital allowances. The Government expects that this information will be provided to them by the lessor and, as such, they are unlikely to see a significant increase in administration costs.

19.67 There will be costs to lessors who need to update or revise their computer software to be compliant with the new regime. This cost should be small in relation to the size of the business. In addition lessors will need to train staff in use of the new software and the products available as a result of the new regime.

19.68 The Government has assumed that businesses will structure leases to take account of the new rules and develop their businesses in a way that enables them to derive maximum benefit from the proposals.

HM Revenue and Customs Costs

19.69 Due to the specialised nature of leasing there will be specific offices and staff that will require training. In addition, guidance manuals will require some rewriting to reflect both the new regime and its interaction with other areas of tax legislation.

Exchequer Costs

19.70 An Exchequer yield will arise from the proposed reform because some lessees, having tax losses, will be unable to use the capital allowances that the lessor can use under the existing regime. Against this, tax will no longer be received from lessors on the capital element of their rentals, but in the case of longer leases there will be a timing benefit from the change in the Exchequer's favour. While for any individual lease this is a timing effect only, given that there is a recurring annual volume of new leases the overall Exchequer effect is 2005 / 06 nil, 2006 / 07 £60m, 2007 / 08 £150m.

Equity and Fairness

19.71 The proposals will not affect a lease if a written contract has been entered into between a lessor and lessee before 1 April 2006 as a result of which the complete asset has been made available to the lessee before that date.

19.72 Transitional rules will allow some leases to be taxed under the existing regime even where they are entered into on or after 1 April 2006. Prior to the new regime becoming law, HMRC published further information on its web site in response to issues raised following publication of the Technical Note in July 2005. At the time these changes become law HMRC will publish detailed guidance on its web site.

Other Impacts

Devolution

19.73 Tax is a reserved matter. As the changes will apply equally to all businesses across the UK we consider that there would be no impact as regards devolution.

Human rights, Social Costs, E-Policy, Environmental Impact, Rural Proofing

19.74 Currently there are no impacts on human rights, social costs, e-policy, environmental impact or rural proofing as a result of this proposal.

Small Firms Impact Test

19.75 There has been consultation with the Small Business Service and representatives of small business. The general consensus was that the reform would have very little effect on small businesses.

19.76 The criteria of the Small Firms' Impact test were applied to this proposal. It is not envisaged that the changes will increase the administrative burden on small business. The records that will need to be kept will be no different to those already maintained by the majority of small and medium sized businesses.

Competition Assessment

19.77 A competition filter test was applied to these changes. The market most directly affected by the changes will be the leasing industry. The distribution of market shares in this industry indicates that it is at least moderately competitive. Those firms with a high level of participation in the long-term 'big-ticket' segment of the market may be disproportionately affected. This may cause some firms to reduce in size.

However, it appears unlikely that the total number of financial and other groups offering leasing services will decline to the extent that the market would become significantly less competitive. The risk that the changes may have a significant detrimental effect on competition is therefore seen as low.

19.78 Other markets potentially affected by this change might be among those, which are users of leasing finance. As mentioned in paragraphs 19.39 to 19.54 firms in some industries may experience a modest increase in cost of capital for investment currently funded by means of leasing. In theory this would be more likely to affect new entrants in such industries than firms with established profits. However, the evidence does not suggest that the current tax treatment of leasing is commonly a decisive factor in encouraging new firms to enter industries. It is therefore unlikely that the change will significantly affect competition in any markets that use leasing.

19.79 In view of these conclusions, a detailed competition assessment is not included here.

Enforcement, Sanctions and Monitoring

19.80 No changes to the existing compliance provisions are required. The normal risk assessment process by which a business's returns and accounts are taken up for enquiry will continue to allow HMRC to check that the self-assessments of businesses are correct.

19.81 HMRC will publish detailed guidance externally and to its staff on these changes as appropriate. The guidance will be published on the HMRC web site. Initial guidance on key aspects of the new regime will be available in early April, with additional guidance published in July.

Post-implementation Review

19.82 These proposals will contribute to the Government's balancing of competitiveness and fairness in taxation. The changes will be kept under review to see how they are working in practice.

19.83 The compliance cost impacts from the changes to the regime will be reviewed as part of HMRC's ongoing compliance cost review programme. In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Implementation and Delivery Plans

19.84 No additional obligations to submit returns, reports or co-operate with inspections arise.

19.85 The legislation imposes the following additional administrative requirements:

- Lessors wishing to claim capital allowances will need to ensure that their records allow them to establish that the leases in question are not long funding leases; and
- A lessee wishing to claim capital allowances under a long funding lease is required to ascertain whether or not the lessor is claiming capital allowances. The Government expects that this will be met by adding an appropriate clause in the lease documentation. The costs of this will be marginal once the necessary systems changes have been implemented.

19.86 A lessee or lessor wishing to be taxed in accordance with the new regime will be able to elect in to the new regime. There is no required form of election although certain information will need to be provided. The cost of making such an election will be insignificant.

19.87 Once the transitional phase is over it is not expected that there will be any significant difference in the administrative burden imposed by the new regime compared to the existing regime.

Summary and Recommendation

19.88 In summary, changes to the leasing legislation will reduce the influence of the tax system on the choice of methods of finance. Such changes will also allow the Government to remove current restrictions on overseas leasing and relax the rules for allocating expenditure when an asset is acquired for finance leasing.

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REGULATORY IMPACT ASSESSMENT

Leased Plant and Machinery (Leasing Reform)

Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:



Dawn Primarolo
Paymaster General

Dated: 15 March 2006

Introduction

20.1 Businesses currently face restrictions on the extent to which they are allowed to get tax relief for expenditure on cars costing more than £12,000. These “expensive car” rules, which were originally introduced in 1961 as a surrogate benefits charge on luxury cars, have been identified by business as an area that would benefit from reform. As a result the Government announced in the 2004 Corporation Tax (CT) Reform Technical Note¹ that it was appropriate to consider options for modernisation. The Technical Note also explained that, while the main aim of any reform would be deregulatory, it was important that any reforms were consistent with wider government objectives on the environment and on maintaining sound public finances.

20.2 Since then the Government has been looking in more detail at possible options, taking account of initial business responses to the 2004 Technical Note (a summary of the responses is provided in Annex A), and has published a consultation document entitled “Modernising tax relief for business expenditure on cars” alongside Budget 2006². This consultation document sets out the results of this work and, outlining criteria for assessing possible options, uses these to develop the Government’s preferred option.

20.3 The purpose of the consultation document is to seek business views on the Government’s preferred option. In particular, on the extent to which it would reduce the compliance costs associated with the current regime, and modernise the regime in a way that supports the Government’s wider objectives. A summary of the questions asked by the consultation document are contained later in paragraph 20.42.

20.4 This Partial Regulatory Impact Assessment summarises many of the arguments and conclusions contained in the main body of the consultation document. In addition it highlights areas where the Government intends to carry out further analysis through discussions with business, in order to inform policy decisions and the full Regulatory Impact Assessment.

Purpose and Intended Effects of the Measure

The Policy Objectives

20.5 The aim of the reform is to modernise the existing tax rules that restrict tax relief on business expenditure on cars costing more than £12,000 (the “expensive car rules”) in a way that reduces associated compliance costs whilst ensuring consistency with the Government’s wider objectives on the public finances and the environment.

Background

20.6 A full description of the current regime is set out in Chapter 2 of the consultation document. In summary, there are special rules for calculating capital allowances on cars that cost more than £12,000:

¹ This is available at: www.hmrc.gov.uk/pbr2004/sup-ct-reform-tech-note.pdf

² Details on how to obtain a copy of this consultation document are set out in paragraph I.39

- the car is not included in the general plant and machinery pool but accounted for separately in an individual pool;
- the writing down allowances are restricted to a maximum annual amount of £3,000; and
- when the car is disposed of, a balancing charge or allowance is likely to be generated.

20.7 There are also related restrictions on the amount of car rental payments that businesses can offset against profits for cars costing more than £12,000.

Rationale for Government Intervention

20.8 From businesses' responses to the 2004 Technical Note, and from wider discussions, it is clear that Businesses have three main problems with the current rules:

- the separate calculation of capital allowances for each "expensive" car and the resulting need to track all such cars imposes a significant compliance burden on businesses;
- the rules are outdated: The benefit in kind element of the provision of company cars are more effectively captured through the personal company car tax rules, and the value of £12,000, above which cars are deemed to be expensive, has not been changed since 1992; and
- the rental restriction is much more restrictive than the capital allowance restrictions, and introduces a tax distortion between cars that are purchased and cars that are leased.

20.9 In response, the Government announced that it was appropriate to consider options for modernisation that addressed these concerns.

Consultation

20.10 These issues were first raised in the 2004 CT Reform Technical Note. A summary of responses is provided in Annex A.

Options

20.11 The Government has considered three options for reforming the current capital allowance rules for cars:

Option 1

20.12 Abolish the current restrictions and treat all cars in the same way as most other plant and machinery in the general pool.

Option 2

20.13 Introduce a new car pool for all cars with a writing down allowance of less than 25 per cent.

Option 3

20.14 Introduce a new car pool for all cars with a writing down allowance of less than 25 per cent, and a range of first year allowances for cars depending on CO2 emissions. This is the Government's preferred option.

20.15 In addition, the Government is willing to revisit the lease rental restriction, but Exchequer constraints mean this could only be achieved as part of an overall package.

20.16 All these options attempt to meet the reform objectives by changing the tax regime, as this is the source of the compliance costs. Non-tax measures were not considered, as they would not achieve this reform objective.

Costs and Benefits

Sectors and Groups Affected

20.17 The proposed reforms would impact on all sectors that purchase cars, and would therefore impact on a vast number of businesses. The impacts would be greatest for businesses that operate large vehicle fleets. They would also potentially impact on all sectors that construct, develop and sell cars as the environmental incentives could change businesses' purchasing behaviour.

20.18 As discussed later, the impact of the options on unincorporated business owners, who also use business cars for private purposes, may be more limited. The possible removal of the lease rental restriction would benefit all firms that lease "expensive" cars.

Benefits

20.19 As outlined in the Consultation Document the Government intends to use the consultation period to gather more evidence on the potential benefits the preferred option would bring to businesses, and would be grateful for any assistance commentators can give in this area. This information will then be used to inform a final decision.

Economic

Option 1

20.20 Of all the options considered Option 1 offers the most significant compliance cost savings. It means there would be no difference between the calculation of capital allowances for "expensive" cars and most other plant and machinery. Cars would therefore be included in the general capital allowance pool and there would be no need to track "expensive" cars for tax purposes.

Option 2

20.21 Option 2 would also deliver compliance cost savings as it also removes the need to track individual "expensive" cars for tax purposes. These benefits would be partly offset by the need for businesses to set up a new capital allowance car pool, and the resulting required changes to tax computation software, although these costs are unlikely to be significant.

20.22 Option 2 also has the benefit that the rate of writing down allowance of the car pool can be set to ensure the option does not result in Exchequer costs, which is also an objective of the reform. However, as the focus of the consultation document is on the basic framework of the various options, and not on possible allowance rates, it is not possible at this stage to produce Exchequer costings.

Option 3

20.23 As with Option 1 and Option 2, the main economic benefit of Option 3 comes from the reduction in compliance costs associated with the current regime, as it removes the need to track individual “expensive” cars for tax purposes. Although businesses would need to identify each car’s CO2 emissions when they are purchased, in order to calculate the appropriate first year allowance, many businesses already have to do this for their company car tax calculations. It is unlikely therefore that this aspect of the option would offset the more substantial compliance cost savings that come from pooling. This option would also significantly reduce the size of the tax return computations.

20.24 As with Option 2, Option 3 also has the economic benefit that the rate of writing down allowance of the car pool and the first year allowances can be set to ensure that the option does not result in Exchequer costs.

Environmental

20.25 Of the three options considered only Option 3 has the potential to deliver any environmental benefits. By linking the rate of first year allowances to CO2 emissions this option would tie-in with other forms of vehicle taxation, and the Government’s wider environmental objectives. Moreover, the option would produce tax incentives for businesses to purchase cars with lower CO2 emissions, which may influence car purchasing behaviour. However the impact on CO2 emissions is hard to predict accurately, given the wide range of factors that influence car-purchasing decisions.

Costs

Economic

Option 1

20.26 Over the first 5 years, the removal of the restriction on capital allowances could reduce tax revenues by around £750 million. This option would therefore run counter to the Government’s fiscal objectives.

Options 2 and 3

20.27 The tax rates and allowances within Options 2 and 3 could be set such that they avoided the additional Exchequer costs described above.

20.28 All the options would involve one-off costs to businesses from changing their systems to cope with the new rules, e.g. learning new rules, upgrading software, form filling, staff training, etc... The Government intends to use the consultation period to gather more evidence on these potential one-off compliance costs.

Environmental

Options 1 and 2

20.29 Option 1 and 2 would both result in cash flow benefits for expensive cars, which tend to have higher CO₂ emissions. These options would therefore be inconsistent with recent reforms to other forms of vehicle taxation, which have attempted to use the tax system to incentivise drivers to purchase cleaner cars. They could possibly result in some environmental costs, although these are extremely difficult to quantify given the lack of evidence on the extent to which capital allowances influence car purchasing decisions.

Option 3

20.30 As this option would incentivise the purchasing of more environmentally friendly cars it would not create any environmental costs.

20.31 The Government intends to use the consultation period to gather more evidence on the magnitude of the potential costs that would be incurred by options 1 & 2.

Small Firms Impact Test

20.32 The main compliance benefits from the lead option come from moving “expensive cars” from being treated individually to being treated in a single pool. However self-employed car owners, who partly use their cars for private purposes, have to keep separate pools for any assets that are used for non-business purposes in order to make the necessary private use adjustments. It is therefore unlikely that they will see a reduction in their compliance burden.

20.33 However from the environmental perspective there would still be a clear case for including the self-employed in these reforms to incentivise the purchasing of cleaner cars. Also to the extent that self-employed individuals and other unincorporated businesses (e.g. partnerships) provide cars for their employees, or own cars they do not use privately, those unincorporated businesses would enjoy the same compliance cost savings as companies would from the preferred option for reform.

20.34 As outlined in the Consultation document the Government intends to use the consultation period to gather extra information on the impact these proposals would have on self-employed individuals and other unincorporated businesses and would be grateful for any assistance commentators can give in this area.

Competition Assessment

20.35 A competition filter test was applied to these options.

20.36 It is expected that vehicle manufacturers are most likely to be affected by reforms to the capital allowances regime for cars. However options 1 and 2 are unlikely to raise competition concerns for UK customers, despite the business fleet market being highly concentrated. Rather reform would result in the equal treatment of all business cars for capital allowances purposes as the current restrictions, limiting the amount of allowance available by car price and financing method, would be removed in both cases.

20.37 Option 3 is similar in design to the reforms to company car tax introduced in April 2002, pegging (company car) tax to CO₂ emissions. The latter was selected as a

case study in a report commissioned by the Department of Trade and Industry on competition issues in the automotive sector. The report concludes that: "...given the size of the industry, the ongoing nature of R&D activities, the impact of the voluntary agreement and the short product lifecycles, it is unlikely that manufacturers' long term ability to compete will be significantly threatened by the reforms. We suggest, therefore, that the reforms to company car tax are unlikely to raise a competition concern for UK customers."

20.38 We believe that the conclusions of the report are also valid for Option 3.

Enforcement, Sanctions and Monitoring

20.39 None of the proposed options are likely to require any further resources to secure compliance.

Summary and Recommendation

20.40 In summary the Government has been considering a range of options for modernising the current restrictions on relief for expenditure on business cars to address the concerns raised by business, whilst ensuring consistency with the Government's wider objectives on the public finances and the environment.

20.41 The analysis summarised in the Partial Regulatory Impact Assessment suggests that modernisation can be best achieved by introducing a new car pool for all cars with a writing down allowance of less than 25 per cent, and a range of first year allowances for cars depending on CO₂ emissions. The Government is also willing to revisit the case for abolishing or modifying the lease rental restriction, but only as part of an overall package.

20.42 The main purpose of the consultation document is to seek views on the Government's preferred option. In particular, the Government would be grateful for views on and any assistance businesses or others can give in estimating:

- The extent to which the Government's preferred option offers compliance cost savings compared with the current rules. In particular, the Government would appreciate any detailed evidence business can provide that would help quantify the size of the compliance cost savings;
- What would be the most effective banding structure to maximise both environmental incentives and reduce the compliance burden. In particular, would the option be more coherent if the bands were aligned with either the current Vehicle Excise Duty bands or based on a variant of the company car tax bands?
- The effect the environmental incentives could have on businesses' car purchasing strategies;
- The extent to which changing the Lease Rental Restriction rules, so that they only applied to the first lessee or only to the final end user of a leased vehicle, would reduce market distortions and reduce compliance costs?
- Whether the compliance cost benefits for the self-employed car owner, who is subject to the private use adjustment rules, would be more limited than those for unincorporated businesses that are not subject to those rules and for companies?

- Whether, for those self-employed who only have cars that they partly use for private purposes, these measures would act as a sufficient incentive to buy cars with low CO2 emissions?

20.43 The consultation document is available electronically at www.hm-treasury.gov.uk/consultations.

20.44 Hard copies may be ordered, free of charge, from the HM Treasury Correspondence and Enquiry Unit by email to: ceu.enquiries@hm-treasury.gov.uk or by telephoning: 020 7270 4558.

Annex A: Responses to the Cars Element of the 2004 Technical Note

A.30 Of the responses received, 50 commented on the proposals for capital allowances and cars including the leasing restriction.

Context of the Technical Note

A.31 The Technical Note offered the opportunity to look at the current rules for giving capital allowances on cars and at the leasing restriction that apply where businesses lease cars with an original market value of more than £12,000.

A.32 The Technical Note did not give any specific options but floated the idea of pooling the expenditure but with a rate of writing down allowance less than 25 per cent, or considering some form of environmentally based reform.

A.33 The Technical Note outlined a number of issues and asked respondents one specific question namely: “What are the views of business on the possible options for the reform of “expensive” cars?”

Compliance Burden

A.34 Without exception all respondents who commented agreed that the current rules were due for reform. A significant number of the respondents said that the current regime imposes a significant administrative burden on businesses, and that the current compliance burden was disproportionate. There was a consensus that any measure to reduce the compliance burden and simplify the capital allowance treatment of cars costing more than £12,000 was to be welcomed.

Pooling

A.35 There was a wide disparity of views on how the current regime for giving capital allowances should be reformed.

A.36 A number of the respondents argued that there was no longer a need to distinguish between the purchase of a car and the purchase of any other business asset qualifying for capital allowances and all expenditure on cars should be taken to the general pool (and so get 25 per cent writing down allowances).

A.37 A number of the respondents welcomed the idea of a single pool for expensive cars. A few went as far as suggesting a reduced rate of writing down allowance.

A.38 Some respondents suggested that if there was a need to keep the current rules then the threshold should be raised to reflect the real cost of an expensive car under present economic conditions.

Environmental Option

A.39 Business had reservations about environmentally based reforms. The main reason given for the lack of support was that it was thought that by necessity this would be more complicated.

A.40 Some respondents also said that the environmental options were unlikely to actually deliver any environmental benefits.

A.41 Those that did think there was scope for an environment-based approach suggested various ways this could be done:

- Using a first year allowance for green cars, which could be an administratively simple inducement;
- Having separate pools with differing rates for cars within given CO2 emission bands; and
- A permanent disallowance on expenditure where the car had emission levels above certain levels.

Leasing Restriction

A.42 A significant number of respondents suggested that the leasing restriction was an unnecessary distortion and should be scrapped.

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PARTIAL REGULATORY IMPACT ASSESSMENT FOR HYDROCARBON OILS DUTY: EXPIRY OF DEROGATION

HYDROCARBON OILS DUTY – EXPIRY OF DEROGATION ALLOWING THE UK TO APPLY RATE OF DUTY TO DIESEL USED IN PRIVATE PLEASURE BOATS

Purpose and Intended Effect of Measure

The Policy Objectives

21.1 The purpose of this document is to gauge the regulatory impact of charging the full rate of excise duty on diesel used to power private pleasure boats. The UK currently allows rebated gas oil (“red diesel”) to be used in pleasure boats, and this bears a reduced rate of duty of 6.44 pence per litre compared with 47.10 pence per litre for unrebated diesel (ultra-low sulphur diesel – ULSD – or sulphur-free diesel – SFD) used on the roads.

21.2 This partial RIA is concerned solely with private pleasure boats. The use of red diesel in commercial craft would be unaffected if the derogation were not renewed, and full relief from duty would continue to be available for commercial marine voyages under Marine Voyages Relief. Red diesel would also continue to be available for a range of other uses, including heating applications, stationary plant, generating sets, diesel locomotives and certain categories of ‘excepted vehicle’.

21.3 On accession to the European Union, the UK policy of charging the reduced rate of duty for diesel used in pleasure craft was allowed to continue under derogation from the relevant EU Directives (initially the Oils Structure Directive (92/81/EEC), which was replaced by the Energy Products Directive (2003/96/EC)). The derogation was originally due to expire in 2001 but was extended for a period of five years.

21.4 The UK is one of five Member States with derogations under the Energy Products Directive permitting the use of red diesel in private pleasure craft, the others being Ireland, Belgium, Finland and Malta. The derogations held by Member States under this Directive are due to expire at 31 December 2006. If a Member State wishes to renew a derogation, a formal request must be made to the European Commission; the procedure is then for the Commission to make a proposal to the EU Council of Ministers, where approval requires unanimous consent.

21.5 The Commission has expressed the view that, unless Member States can show that renewal is in the interest of reducing distortion of competition, promoting the better operation of a single market or protecting the environment, derogations should not be renewed.

21.6 The Government has considered the effects of not applying for renewal of the derogation against the grounds which the Commission has given. The Government has also considered regional impact and health and safety aspects, which it considers relevant in deciding whether or not to apply for renewal of this derogation.

Consultation

21.7 The policy has been developed taking into account views gathered informally from stakeholders in UK boating, including the British Marine Federation (BMF), the

Inland Waterways Association (IWA), the Royal Yachting Association (RYA) and the Federation of Petroleum Suppliers (FPS). Other Government departments, such as the Department for Trade and Industry, have also been consulted. All of these bodies have provided evidence, which has been used in producing this assessment.

21.8 It is intended that this assessment will continue to be developed in the period leading up to the expiry of the current derogation.

21.9 Most stakeholders have expressed support for the retention of the derogation and hundreds of private boat owners have written to Ministers supporting retention of the derogation. The RYA, BMF, IWA and FPS have united to provide one document produced in July 2005 (“Seeing Red” – the campaign for the retention of the current derogation on use of red diesel), which they have used in arguing for extension of this derogation.

21.10 The arguments include the serious impact that removal of the derogation would have on boat usage, regional economies and tourism, and the UK marine industry. In addition, it is suggested that both the industry and HM Revenue and Customs would face compliance problems if the derogation ended, and that there might also be environmental and health and safety implications (assuming that boat owners changed to petrol engines or that waterside diesel became less readily available).

21.11 A few individuals have, however, responded in favour of removing the derogation, arguing that allowing the use of red diesel is an unjustified subsidy for a hobby, which encourages the use of high horse power, deep displacement craft with high fuel consumption.

Options

1. Allow the derogation to lapse and require pleasure boat users to use conventional road diesel ((ULSD or SFD)

21.12 Under this option, there would be a small gain of revenue to the Exchequer but extra compliance burdens on the industry and HMRC in collecting any duty.

Apply for renewal of the derogation to allow the UK to permit the continued use of rebated oils in pleasure boats for a further period of 5 years

21.13 Under this option, the UK would not be required to make any legislative or administrative changes to the current system of duty on diesel used for pleasure boats. The potential revenue from applying the full rate of duty would, however, be forgone.

Benefits

1. Allow the derogation to lapse

21.14 Under this option, HM Treasury estimate that there would be an increase in revenue of £10m a year, but only if the sale of waterside diesel were unaffected. The revenue increase would depend on the size of the behavioural effect from the increase in the duty. An RYA Survey indicates that up to 54% of all boat owners who currently use red diesel might give up boating altogether. The most significant behavioural effect

would come from owners of motorboats, where it is estimated that up to 72% of participants might give up boating.

2. Apply for renewal of the derogation

21.15 This is the option adopted. The Government believes that removal of the derogation would result in unacceptable compliance costs. It also believes that, on balance, the environmental, social and market effects of ending the derogation would also be detrimental.

Costs

1. Allow the derogation to lapse

21.16 Under this option, the Government believes that the compliance costs from ending the derogation would be likely to be an unacceptable burden on three groups due to:

- costs to pleasure boat users;
- costs to the fuel suppliers; and
- costs in administration and enforcement for HMRC.

Costs to Pleasure Boat Users

21.17 The BMF estimates that there are approximately 463,000 boats over 2.5 metres in the UK, of which approximately 349,000 are motor boats and therefore rely solely on engines for propulsion, albeit consumption can vary enormously between different types of boat, and that many smaller craft will in any case be using petrol and therefore will already pay the full road fuel duty rate. Many boats are now also fitted with diesel-powered heaters.

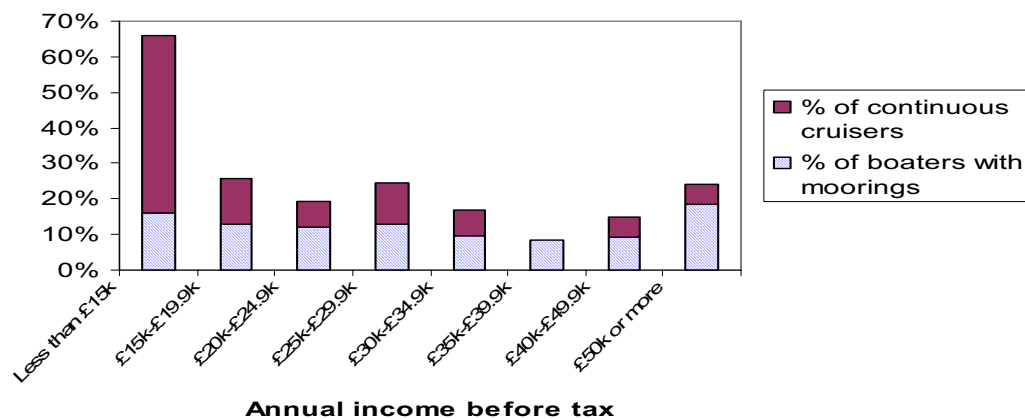
21.18 The use of rebated fuel to provide heat and light on boats would still be permitted. Boats kept on the inland waterways are often used for residential purposes or long term cruising, and will typically use more diesel for heating and lighting than a boat kept on the coast. The Residential Boat Owners' Association have recently carried out a survey, which suggests that there are approximately 15,000 residential boats in the UK, mostly on inland waterways. For these boats, they suggest that the average yearly usage of diesel is 1200 litres. Of that amount, over 60% is on average used to provide heat and light.

21.19 If boat owners wished to continue to use red diesel, they would have to add an extra tank: one for fuel to propel the boat, and another for fuel for other purposes such as cooking, heating and lighting. The cost would vary depending on the size and design of the boat, but it is estimated to be in the region of £750 for a typical inland cruiser. In some cases the technical aspects of installing a new tank might give rise to increased costs, and the design of a vessel might inhibit the installation of an additional tank.

21.20 If a separate tank system were not installed, the extra cost to homeboat owners of unrebated fuels used for purposes for which they were not entitled to use red diesel is estimated as on average £300 a year (i.e. average use of almost 720 litres of fuel per year for non-propulsion purposes multiplied by a difference of 40.66 pence per litre between red diesel and ULSD). The total cost to homeboat owners, who form only a small proportion of pleasure boat users, could be as much as £4.5 million a year. Other boat owners could, of course, refit their boats with twin tanks, but on average this would cost approximately £750 for a typical inland cruiser.

21.21 Given that the proportion of inland boat owners on low or reduced incomes is far greater than for boat owners as a whole, the costs of fitting a new tank would have a disproportionate effect on the inland waterways sector, including inland tourism. A sample survey by the British Waterways Board, to which 1769 boat owners replied in 2004, showed that the majority of boat owners with continuous cruisers earned less than £15,000 a year before tax, while the majority of boat owners with moorings lived below the average household income rate – see the table below for further details.

Chart 21.1 Comparison of Household Income



Costs to the Fuel Suppliers

21.22 There would be a cost for marinas and small ports that currently service boats using rebated oils only. As noted above, commercial boats, which use the bulk of marine fuel, are entitled to use rebated fuels. At present, therefore, suppliers need stock only one type of fuel. If, however, pleasure boats had to use unrebrated fuel, suppliers would face the choice of either:

- not installing extra fuel tanks and pumps and therefore forgoing either the pleasure boat or the commercial market; or
- installing extra pumps and tanks that would allow them to supply both markets.

21.23 A BMF survey of the effects on leisure diesel suppliers of removing the derogation indicated that, of 114 companies who responded to the survey, 24% would install new pumps and tanks to accommodate two fuels, 32% would continue to stock rebated fuels only, and 44% would switch over from supplying red diesel to ULSD. There would be different costs for each of these groups.

Those Opting not to Supply ULSD

21.24 The cost for this group would be lost business in terms of being unable to supply fuel to the pleasure boat market. The impact on the 36 businesses in the BMF survey is estimated to be on average £158,774, which equates to £5,715,864 in total. The survey represents a small fraction of those companies potentially affected.

Those Opting to Supply Only ULSD

21.25 For this group there would be two costs. First, in order to move from supplying red diesel to ULSD, they would have to have their tanks commercially cleaned to remove traces of red diesel. The BMF estimate that the cost of such cleaning would be over £1000 for each tank, however, one BMF member had a recent quotation for £2,500

per tank. Although tanks can be de-contaminated, the general consensus is that the red dye of the diesel could never be removed completely, and this raises issues for testing and enforcement.

21.26 Secondly, there would be additional costs because the fuel would be more attractive to fraudsters than red diesel. Fraudsters will usually remove the dye from red diesel in order that the fuel can be used in road vehicles. However, as this costs time and money, obtaining and selling ULSD is more attractive and profitable for fraudsters.

21.27 Many businesses proposing to supply ULSD might therefore have to increase their security considerably in order to protect themselves from this threat. It is difficult to get an indication of cost as security measures will vary, but the BMF estimate between £1000 and £5000 depending on the sophistication of the system installed (which might include fencing, CCTV, and alarms). In addition, the FPS estimate that there would be a recurring cost of £500 per month.

21.28 Commercial diesel users could potentially use ULSD supplied by these outlets and claim back the duty paid as they currently do with rebated fuel. However, since the fuel used would now carry a duty rate of an extra 40 pence per litre, there would be a cost to them in terms of loss of cashflow from the time of payment to receipt of a refund from HMRC.

21.29 The cashflow could be significant depending on whether the boat was a small fishing boat under ten metres, which will use on average 1,000 litres of fuel a week, or a trawler over 15 metres long, which will use on average over 9000 litres a week. The cashflow loss for a small boat would potentially be £406 a week, while the potential loss for a trawler would be almost £3360 a week. It is unlikely, therefore, that commercial users would buy ULSD in these circumstances, leading to a loss of business for suppliers. Commercial boat owners would also lose out in that the number of locations where they could refill their tanks would be reduced.

21.30 The higher retail cost of ULSD might mean that some businesses would be unable to obtain sufficient credit to secure a supply. The choice of suppliers might also be restricted as many oil distributors no longer deal in road fuels because of the poor margins and high credit risks. This problem is perhaps more significant in the UK than other Member States with have lower duty differentials between road fuels and off-road fuels.

**Those Opting
to Supply
Both ULSD
and Red Diesel**

21.31 Although this group would not suffer any loss of trade, it would face additional costs for installing new tanks and pumps for the second fuel. The estimated cost of adding a tank is £20,000 (consisting of £12,000 for the tank, £6,000 for the pump and £2,000 for installation). In addition, installation of ULSD would also have a potential opportunity cost in that space in marinas is often limited and the space taken by additional tanks could, for example, have been used as berthing for a boat. There would also, as mentioned above, be potential additional costs in terms of providing extra security for the fuel.

21.32 In some locations it might not be possible to install additional tankage, so this option would not be available. In addition, the cost of planning applications might be significant. Such applications typically cost around £200, with additional costs of engaging a planning adviser and preparing detailed plans. Capacity for an extra tank is a major issue and could also have safety implications.

21.33 The BMF survey of fuel suppliers suggested that 92% of those who had replied to the survey believed that the removal of the derogation would have a detrimental effect

on their business. Of the 114 companies who replied, 94 gave an estimate of the loss to them, in terms of both business lost and additional costs. The figure for this group alone amounted to £9.7 million, which represented 15% of these companies' turnover. The removal of the derogation would therefore have a significant financial impact on these companies.

Costs to businesses and HM Revenue and Customs in terms of extra compliance costs

21.34 HMRC would face additional assurance costs if the derogation were removed. At present, suppliers of rebated fuels are registered by HMRC in their Registered Dealers of Controlled Oils scheme (RDCO). This places requirements on dealers to maintain records of purchasers of rebated fuels and the purpose to which they are put in order that misuse can be more easily detected.

21.35 The net effect of removing the derogation would be that some of those currently registered under the RDCO scheme would stop supplying rebated fuels and therefore there would be a small compliance saving for these suppliers. However, there would be additional assurance costs for HMRC in those instances where suppliers decided to supply rebated and unrebated fuels alongside each other. Since this would greatly increase the possibility of misuse or fraud, HMRC assurance would therefore have to be much tighter than if just one fuel were being supplied.

21.36 Prevention of misuse would also be made much harder for HMRC if boat owners installed two tanks. Records could show that a boat filled up with both fuels, but whether or not the rebated fuel was being used properly could not be established from this information alone. At present, pleasure boats are a low fraud risk for HMRC in that they are entitled to use red diesel.

21.37 If that entitlement were removed, pleasure boats in the UK would become an additional fraud threat and HMRC would have to spend more resources in ensuring that red diesel was not misused. HMRC estimates that it would need five extra staff to check compliance at a cost of approximately £250,000 a year. It would also have to invest in additional testing equipment for sampling fuel from boats.

21.38 In addition, it would be difficult for HMRC to establish clearly whether there had been fraud. A boat might legitimately have traces of red diesel in its engines subsequent to the removal of the derogation for a number of reasons that would make prosecution difficult. Pleasure boat users could, for example, claim that:

- The fuel had been purchased in the UK before the expiry of the derogation. Since many pleasure boat owners are only occasional users and use is seasonal, a lot of boats would be laid up in harbour if the derogation expired on 31 December 2006. It might then be 2-3 months before owners used their boats again, so that many boats would have rebated fuels in their engines for many months after the end of the derogation.
- Traces of red diesel found after expiry of the derogation would not necessarily demonstrate misuse but simply that red dyes took a long time to clear from engines. The only way of tackling this issue would be to require all pleasure boat owners to clear their tanks of rebated fuels before 1 January 2007 and then to have their engines industrially cleaned so that there were no traces of red dyes left in the engine.

- However, as with the land tanks, the general consensus is that even with industrial cleaning, remnants of the red colour would be impossible to remove completely. Given that there are approximately 350,000 pleasure boats over 2.5 metres in the UK, the cost of such an operation could exceed £1.5m (assuming all these boats had a diesel engine and that it would cost on average £500 to clean a tank). The Government would not fund such cleaning, and it would have a disproportionate effect on boat owners who were retired or on low incomes. There would also be a high risk of marine pollution as a result of flushing out tanks.
- Boats could take on fuel in the Channel Islands. The Channel Islands are outside the EU, but could continue to supply gas oil from UK refineries that has had fiscal markers added. Thus traces of dyes in engines would again not necessarily prove that there had been misuse of rebated fuels.
- Boats could also have changed uses; for example, a boat that had been used for commercial purposes would legitimately have used red diesel, but if it were then used as a private pleasure craft, rebated use would be prohibited although traces of dyes would still remain in engines. Effective enforcement by HMRC would be all the more difficult because boats chartered without crew for private use would not be allowed to use rebated fuels, although rebated fuel use would be permitted if the same boat were chartered with crew. HMRC would therefore face the additional assurance difficulty of ensuring that any claims for repayment of duty for commercial use were genuine.

2. Apply for extension of the derogation

21.39 The main cost of renewing the derogation would be the loss of potential revenue from use of ULSD rather than rebated fuel by pleasure boat users. The potential revenue gain from ending the derogation is estimated to be £10 million a year at most, but it is unlikely that this amount of revenue would be collected in practice, because the removal of the derogation would be likely to reduce pleasure boating activity in the UK.

21.40 As noted above, the RYA survey suggested that 54% of those who replied would consider giving up boating altogether if the derogation were removed. There might also be increased ‘cross-border’ shopping, particularly on the south coast, where owners of fast motor cruisers with large fuel capacity could fill up with cheap diesel on the other side of the Channel. Others might consider relocating their boats permanently outside the UK, taking advantage of generally lower costs and the availability of cheap airfares.

21.41 While the estimated extra revenue does take into account some reduced fuel use due to the increase in duty, it is difficult to estimate the full effect on consumption of not renewing the derogation, but clearly the more boat owners gave up boating or purchased fuel from outside the UK, the lower the revenue gain would be.

21.42 Loss of diesel sales from those who claim they would definitely stop purchasing diesel could result in potential revenue loss to the Government of approximately £2.5 million. The RYA survey estimates that if all those who claim they would potentially or definitely stop purchasing diesel actually follow through with their intention, there would be a potential loss of revenue of approximately £0.5 million

21.43 The BMF survey “BMF European Overview 2004” also estimates that spending by boat owners, currently estimated at £700 million per year, is likely to fall to an

estimated £550 million if there is a decrease in participation and boat usage as suggested in the “Seeing Red” report.

21.44 There are around 5000 businesses in total that might be affected by changes in boating participation and behaviour, so that the detrimental impact could extend beyond the marine industry, with implications for job losses, resulting in the loss of tax revenue. When this is offset against the cost of enforcement, it can be argued that, while ending the derogation might raise negligible sums, it would be more likely to reduce revenue to the Exchequer.

21.45 In addition, the leisure marine industry is currently a UK manufacturing success story. Over the past five years it has grown by 36%, according to the BMF. However, the economic impact of losing the derogation would put the whole sector under threat, including boat builders, chandlers, holiday companies and marinas.

Competition Assessment

21.46 To some extent the fuel supply network at ports has grown up as a niche market to serve pleasure boats. Those companies involved in supply are often very small enterprises, sometimes being set up as associations or clubs to serve their members. They would therefore be disproportionately affected by the removal of the derogation.

21.47 It is likely that many companies might withdraw from supplying fuel if the derogation expired (see reference above to the BMF survey of fuel suppliers). This would therefore distort the current market further by reducing the number of suppliers at ports and harbours. Smaller companies that remained in the market would be unable to compete with the oils majors who supply ULSO to their forecourts, and would lose business as pleasure boat owners looked to forecourts for fuel supply. This would have a number of undesirable side effects:

- it would mean that fuel was travelling longer distances than before if owners were transporting it from major forecourts to their boats;
- the carriage of fuel in this way would have health and safety implications, particularly if it were transported in inappropriate containers; and
- it would increase the possibility of leakage of diesel into the waterways if it was being decanted by owners into boats rather than through pumps.

21.48 There might also be detrimental environmental effects from boats carrying heavier loads of fuel, and therefore consuming more fuel, because there would be likely to be fewer fuelling sites available to them after the end of the derogation. The BMF survey showed that in some areas of the UK there was a distance of 70 miles between one fuelling point and the next. The BMF found that there might be almost a third fewer suppliers of fuel for pleasure boats if the derogation ended, so that this problem would be exacerbated.

21.49 Given the geographic and demographic features of the UK (where there are many long stretches of coastland with few inhabitants and consequently supporting fewer businesses), this would be a particular problem for pleasure boat owners in areas such as Cornwall, Scotland, Wales and Northern Ireland, where there are already few refuelling points.

Effects on the Scottish Coast

21.50 The Royal Scottish Motor Boat Club (RSMC) provided a report in July 2005, which looked at the effects of removing the derogation on Scotland and this provides a useful example of the problems that removal of the derogation might cause in some of the more remote and rural areas of the UK which have long, sparsely populated coastlines. As the report pointed out, there is a distance of some 480 miles from Largs at the bottom of the West Coast to Portree, a port in Skye, at the top of the West Coast.

21.51 Along that coastline, there are fewer fuel sites further north, away from the major conurbation around the Clyde, which contains Glasgow. The distances between refuelling locations also are significant. After Oban, for example, it is 25 miles to the next refuelling site at Tobermory, then after that a further 32 miles to the next site at Mallaig, then another 20 miles to Kyle of Lochalsh and then another 20 miles to Portree. These distances might become greater since some sites would not stock conventional diesel if the derogation ended, owing to the costs.

21.52 The RSMC report cites the refuelling site at Kyle of Lochalsh as an example, with having estimated costs of £20,000 to fit conventional diesel pumps and tanks. The refuelling site has decided that it would therefore not provide conventional diesel and would only provide red diesel for commercial users. The report also shows that, even in the Clyde area, where there are currently seven suppliers of fuel to pleasure boat owners, two of these suppliers are unlikely to stock conventional diesel in the event of the derogation ending and indeed, since the remaining five locations will be marinas, their opening hours may be limited.

21.53 In addition, because of the small population along these coasts, there are few filling stations even for road vehicles; in the North of Scotland, there may be distances of 50 miles between filling stations.

Market Distortion

21.54 The removal of the derogation could cause market distortions in encouraging many UK boat owners to base their boats in other Member States. The RYA survey indicates that 51% of respondents said they would consider keeping their boat abroad if the derogation were not renewed. Within that group, a greater proportion of owners of more expensive motorboats would be likely to remove their boats, while less well off boat owners who might be unable to afford to resite their boats would be hit harder.

21.55 In addition, there would be further market distortions as cross border shopping for fuel would be more attractive (e.g. it would be more attractive to go to the Channel Islands, France or Ireland to restock with cheaper fuel than it is at present). The boat owners who would be likely to move their vessels abroad typically use much more fuel than average - about 5,000 litres a year. The UK would therefore lose the largest consumers of fuel overseas, and this could lead to a reduction in the revenue raised.

Equity and Fairness

21.56 It could be argued that the current derogation gives unfair advantages to pleasure boat owners, who, unlike motorists, pay a reduced rate of duty for their fuel. Nevertheless, a more accurate comparison would be between commercial and private boats rather than private boats and private motorists. As commercial boats are able to reclaim all duty paid on fuel they use this seeming benefit for pleasure boat owners is not in fact as great as it might appear

Small Firms Impact Test

21.57 The relief benefits users of diesel in pleasure boats, but the majority of companies in this sector are very small. The “Seeing Red” survey, for example, suggests that “ the marine leisure industry is predominantly comprised of small and medium-sized enterprises”. Indeed, many are small family owned companies. The effects of ending the derogation might well prompt many to abandon this market altogether, in particular given the extra compliance costs which would prove onerous for most of them.

21.58 The impact of the loss of the derogation on all diesel suppliers surveyed by the BMF represented 15% of their combined turnover, but there would be a disproportionate impact on smaller companies: for those with a turnover of under £100,000 it would be 39%; and for a company with a turnover under £200,000 it would be 26%.

21.59 The RSMYG report gave an example (mentioned earlier) of a fuel supplier in Kyle of Lochalsh who faced costs of an estimated £20,000 to install additional tanks and pumps to supply two grades of fuel. Given the limited turnover of the business, it was decided that such an investment was not practicable.

21.60 In addition to those directly involved in boating, there are many other associated smaller businesses that would be badly hit by the ending of the derogation. In some ports, for example, following the decline of the UK fishing industry there has been a deliberate attempt to build up businesses aimed at serving pleasure boat owners to replace the trade lost from the fishing industry.

21.61 The RSMYG report mentions, for example, how the Isle of Muck has established a restaurant in its community hall to serve pleasure boat visitors. If the derogation were to end, these and many other small businesses serving this market would be badly affected. In Norfolk, for example, there are many small companies that hire out holiday boats for use along the canals.

21.62 The “Seeing Red” survey estimated that the effect of losing the derogation would lead to an extra £50 a week on average being added to the costs of a canal holiday, which would make these holidays significantly less competitive and thus reduce demand. The costs would be even higher for a boat travelling around the west coast of Scotland - the RSMYG report estimated that the cost of a two week cruise on a forty foot motor cruiser would increase by over £1,000, and a weekend cruise from Largs to Tarbert would increase by £175, if the derogation ended.

21.63 In addition, any decline in the use of inland waterways by pleasure boats could affect many small businesses along the waterways, such as restaurants, public houses, and small shops.

21.64 A number of charities and voluntary organisations might also be affected disproportionately by the ending of the derogation. There are for example a number of organisations that teach children and young adults how to sail, and some of these offer socially deprived children the chance to holiday on a boat.

21.65 The National Community Boat Association (NCA), for example, is an umbrella organisation representing 97 charitable organisations who use their boats to give holidays to the socially excluded. In 2003, for example, this group provided over 200,000 passenger days, mostly on internal waterways, for the socially deprived. The NCA have

said that small charities, such as their members, will be hit particularly by the ending of the derogation since they have limited and fixed incomes, often based on grants.

Enforcement, Sanctions and Monitoring

21.66 HMRC believes that removal of the derogation would necessitate extra resources for assurance. It would increase the risk of fraud or misuse at many fuel suppliers who would have two types of fuel for sale alongside each other. In addition, the policing of this change in legislation would be difficult since, as pointed out above, it would be difficult to detect misuse, given that there are a number of legitimate reasons why dye from rebated fuels might be found in pleasure craft subsequent to the expiry of the derogation.

Implementation and Delivery Plan

21.67 In the event of the derogation not being renewed, HMRC would publish guidance on how they would deal with this issue, and what transitional arrangements would be put in place.

21.68 If fuel suppliers elected to supply both rebated fuel and ULSD, any new storage tanks would have to comply with the Control of Pollution (Oil Storage) (England) Regulations 2001 (similar regulations are to be introduced in Scotland, Northern Ireland and Wales) which require larger and more expensive tanks than were previously permitted. Planning permission would also be needed, which can typically take up to 18 months to complete. It is likely that planning permission for additional fuel tanks will be a more sensitive issue than previously as a reaction to the Buncefield incident.

Post-implementation Review

21.69 If the derogation is extended, it is likely to be for a maximum of five years. HMRC would work with the industry during that period to review the justification for any further extension.

Summary and Recommendation

21.70 The Government believes that the balance of advantage lies with retaining the derogation. Its removal would cause market distortion and would have significant compliance costs for both the industry and the Government. In addition, Annex A lists other factors that have influenced the Government's decision to apply for renewal of the derogation.

Annex A - Additional points considered in deciding that the UK should request renewal of the derogation allowing the use of rebated fuels in private pleasure craft.

HEALTH AND SAFETY ISSUES

Ending the derogation might encourage the use of petrol engines in private pleasure boats

A.43 It has been suggested that, if the derogation were to end, some boat owners would convert or replace their engines to run on petrol, and that, as petrol is a much more volatile fuel, the risk of fire and explosion would be much greater.

A.44 On balance, we do not believe this would be a significant risk, since the cost of replacing or converting an engine would be substantial and would be greater than any saving possible from switching fuels. In addition, while diesel is more expensive on UK forecourts than petrol, diesel engines give greater fuel economy, so it seems unlikely that there would be any real benefit in such a change. However, there might be a move towards petrol engines in new craft, especially as new petrol engines are typically 40% cheaper than comparable diesel engines.

A.45 Should the safety of petrol engines become an issue that needs to be addressed it might be more appropriate to deal with it through regulation rather than through a tax incentive to encourage the use of diesel.

ULSD may have detrimental effects on some boat engines

A.46 Some boat owners have argued that, since ULSD has less lubricity than red diesel, it can affect engine performance and make them more likely to break down. This could have safety implications given that it could lead to boats being left powerless in the sea. In particular, we understand that as conventional diesel has less of the “aromatic” compounds that are found in red diesel, seals in the engine pump are more prone to shrinkage and wear, thus leading to fuel leakage (an unwelcome development if this increases river pollution) and loss of engine pressure.

A.47 We realise, however, that boat owners will have to tackle this issue in the longer term anyway since the EU Directive on sulphur levels in liquid fuels will lead to red diesel sulphur content being brought down to the same level as that for ULSD.

A.48 Under the Renewable Transport Fuels Obligation, all ULSD may in future contain at least 5% biodiesel. This will make the fuel more hygroscopic than red diesel, as biodiesel can absorb water in a concentration of up to 1,000 parts per million during storage. Once the solubility limit is exceeded, water separates inside the storage tank and collects at the bottom, causing problems that could lead to engines breaking down and corrosion of the fuel tanks.

Some boats could be stranded as a result of reduced availability of fuels

A.49 It is possible that this could happen given that ending the derogation would be likely to reduce the number of fuel suppliers in the UK. We do not believe that this would be a significantly greater problem than it is now. It would be for boat owners to take adequate precautions to ensure that they had sufficient fuel on board to cover their journey. However, smaller vessels (particularly motor vessels) might be unable to carry sufficient quantities in spare containers and the owners of such craft might have no option but to avoid the more remote and rural areas of the UK.

Fitting double tanks on boats may cause safety problems

A.50 If the derogation ended, boat owners might well fit additional tanks to their boats in order to continue to use rebated oils for heating, lighting, and cooking, although it might be difficult to ensure that boats refitted in such a way conformed with the Boat Safety Scheme requirements, particularly if the new tanks limited the space for movement on board.

ENVIRONMENTAL EFFECTS OF THE DEROGATION ENDING

A.51 Ending the derogation would be likely to lead to little or no savings of fuel. Although UK consumption of diesel by pleasure boats would be reduced, much of that reduction could be offset by consumption of fuel bought in other Member States by boats relocated there or through cross border shopping for fuels which could actually lead to higher consumption. In addition, having potentially fewer refuelling sites available might mean that more boats carried fuller tanks of fuel, making them heavier and therefore increasing their consumption.

A.52 In addition, if boat owners had to buy road diesel at marinas or elsewhere, it is likely that some of them would buy red diesel in 25 litre containers and fill up their tanks from these containers. Red diesel can be bought at some garages in rural and other areas where there is demand for its use in off-road machinery and vehicles. There would be an increased risk of spillages if fuel were decanted from these containers into boats' fuels tanks. This risk would also arise if marinas ceased stocking fuel because of the prohibitive costs of road diesel, so that boat owners were forced to buy fuel in containers and decant it.

NUMBERS OF LEISURE BOATS IN THE UK 2003

Table 21A.1 UK Leisure Boat Ownership 2003

Boat Length	Sail	Motor / Other	Personal Watercraft
2.5 – 7.5 metres	74,950	288,731	
7.5 – 12 metres	26,982	41,687	
12 – 24 metres	4,925	1,298	
24+ metres	15	21	
Total	106,872	331,737	12,094

A.53 Boat Ownership – the number of boats owned by citizens at home is 451,000 as shown above. A further 90,000 owned by citizens abroad.*

Table 21A.2 Leisure Boats based in the UK 2003

Boat Length	Sail	Motor / Other
2.5 – 7.5 metres	79,692	303,622
7.5 – 12 metres	28,689	44,026
12 – 24 metres	5,500	1,4256
24+ metres	17	27
Total	113,898	349,097

A.54 The figures for boats based in the UK include those owned or hired by residents of other, European and non-European countries.*

* Data are taken from the BMF, European Overview 2004

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Purpose and Intended Effect of Measure

The Policy Objectives

22.1 To maximise customer take-up of the online services offered by HM Revenue and Customs in order to:

- provide a better and more cost effective service for customers;
- encourage wider use of new technology that can provide wider benefits for customers; and
- capture clean, easily processed data to help drive down costs for the department and the taxpayer.

22.2 The aim is to encourage all customers, and in particular business customers, to file income tax self assessment (SA), company tax (CT), value added tax (VAT) and pay as you earn (PAYE) returns online.

Background

22.3 The Government has invested over £500 million in HM Revenue and Customs online services. The return on this investment will come in the form of improved services for our customers, lower operating costs and greater service delivery flexibility. To maximise the benefits the services need to be robust and customer orientated. HMRC is planning to spend some £340 million in online service infrastructure over the next 9 years. The investment will be focussed on improving the existing services so that they are resilient and tailored to user's needs.

22.4 Nearly 25% of Income Tax Self Assessment returns are now received online and this has grown year on year since the service was introduced in 2000-01.

22.5 An electronic VAT return was introduced in 2001 and 7% of VAT traders have signed up to make returns on-line since an improved online VAT service was launched in 2004.

22.6 A corporation tax (CT) online filing service was introduced in 2003, and we have received around 20,000 company tax returns in the last year .

22.7 During 2005, HMRC received more than 24 million Import and Export declarations for non-EU consignments. More than 99% of these declarations were submitted electronically.

22.8 This shows that slow but steady progress in increasing levels of take-up of online services can be achieved through voluntary adoption. However, more pro-active measures are needed if the benefits are to be fully realised.

22.9 Following Patrick Carter's Review of Payroll Services¹, the Government announced a three-stage move to universal online filing of employers' end of year returns. The first stage, for large employers, was implemented in Spring 2005 and there

¹ Published at Pre-Budget Report 2001 - www.hmrc.gov.uk/pbr2001/carter_review.pdf

has been a dramatic increase in the use of the PAYE service. The Carter measures included financial incentives for smaller employers if they moved to online filing ahead of the requirement for them to do so in 2010 and more than 60% of small employers took advantage of this in 2005.

22.10 In July 2005, the Government asked Lord Carter to undertake a Review of HMRC Online Services. The purpose of the review was to look at ways of increasing take up of online services for SA, VAT, CT and PAYE and maximising benefits for customers whilst ensuring that the department continues to deliver sustainable and efficient services that support compliance.

Rationale for Government Intervention

22.11 Failure to increase the speed of customer adoption of online channels would mean that

- customers, and businesses in particular, would not gain from the benefits that adoption of online services can provide in terms of reducing their compliance costs.
- HMRC would not realise the significant administrative savings that can be achieved with greater take-up.

Options

1. Do Nothing

22.12 Option 1 is to do nothing extra and hope that, through continuing investment, service enhancement and promotion, levels of voluntary use of online filing will continue to increase. However, though progress has been made it has been relatively slow. We project that voluntary adoption will plateau and that widespread adoption will not be achieved without further action.

22.13 Lord Carter's report identifies a relative reluctance to engage with Government online, even among businesses and taxpayers that use IT for other tasks. Other research also indicates that UK businesses are far less likely to use public sector websites than their European counterparts². In this context, we do not believe that reliance on organic growth will be a sustainable approach and so we have rejected it in favour of the more pro-active approach recommended by Lord Carter.

2. Lord Carter's Recommendations

22.14 Option 2 is the package of measures recommended by Lord Carter. His proposals build upon his previous recommendations in his Review of Payroll Services. For Corporation Tax (CT), Value Added Tax (VAT) and in-year Pay As You Earn (PAYE), the proposals are for the phased introduction of compulsory online filing³.

22.15 For Self Assessment (SA), the proposals are to stop accepting software generated paper returns ("substitute returns"), reduce the filing periods for all SA returns but allow a relatively longer period for filing returns online. All of these recommendations

² Eurostat report: e-Government 2004: internet based interaction with European businesses and citizens - <http://www.egovmonitor.com/reports/rep12340.pdf>

³ It is expected that an exemption will be provided for groups that have a religious conscience objection to the use of computers and the Internet

are subject to the right “building blocks” being in place before the measures are implemented, in particular the availability of robust services that can cope with high volume usage at peak times. The analysis that follows assumes this will be the case, but we will be keeping the position under review as we move towards implementation.

PAYE 22.16 The three-phase move to compulsory online filing of employers’ end of year returns is already underway and will be complete in May 2010. Employers using payroll software will see year-on-year benefits as the software generates clean data from the point that staff records are created, and helps to avoid problems at the end of year. The announcement of compulsory online filing saw a huge demand-driven increase in the number of payroll products that could be used for online filing.

22.17 Lord Carter’s Review of Payroll Services in 2001 also recommended that employers should, in time, be required to send in-year forms electronically. He now proposes that employers should be required to use online services for starter and leaver forms (P45 and P46) on the following timescale:

- from April 2008 for large and medium sized⁴ employers; and
- from April 2010 for all other employers.

VAT and Corporation Tax 22.18 VAT and CT are business taxes. Most businesses that pay these taxes already use information technology⁵ or will be able to make the move to using it without too much difficulty. Many small businesses will be employers and will have received financial incentives to help them make the transition to online filing for PAYE.

22.19 The proposals for VAT and CT are aligned so far as possible, but mandatory online filing of company tax returns (for corporation tax purposes) will not start until 2010 to allow for service improvements and the bedding down of XBRL⁶.

22.20 The proposals for VAT are as follows:

- online filing of VAT returns, and electronic VAT payments required for traders with an annual turnover of more than £5.6 million for accounting periods starting after 31/03/08;
- online filing of VAT returns, and electronic payment of VAT, required for traders newly registering for VAT after 31/03/08; and
- online filing of VAT returns, and electronic payment of VAT, required for accounting periods starting after 31/03/10, for all traders with an annual turnover greater than £100,000. (The continuing need for this exemption will be reviewed in the run up to 2012, in line with Lord Carter’s recommendation that HMRC should aim for universal electronic delivery of the main business tax returns by 2012).

⁴ Those with 50 or more employees

⁵ ONS report *Information and Communication Technology (ICT) Activity of UK Businesses (2004)* indicates that nearly 70% of all businesses were using ICT by 2004, and over 90% of those with 10 or more employees. We expect these figures to continue to increase in the run up to 2008 and beyond.

⁶ Extensible Business Reporting Language: ICT standard for business financial reporting

22.21 The proposals for CT are that:

- online filing of company tax returns and use of XBRL for the accounts and tax computations required for all companies for returns due after 31/03/10; and
- the enquiry window, for most companies⁷, will to be linked to the date the return is filed by 2010⁸.

22.22 An XBRL⁹ facility, which enables tax computations to be submitted in data form rather than as scanned attachments, was provided as an enhancement to the Corporation Tax online service in February 2006. The service will be expanded to include accounts when a suitable taxonomy is in place, probably in summer 2006. Companies will be required to use XBRL from April 2010 and PDF attachments will no longer be accepted.

Income Tax Self Assessment

22.23 Income Tax Self Assessment applies to individuals, partnerships and trusts. Included within these groups are the self-employed, employees with additional sources of income and pensioners. Within this population there is a very wide range of behaviours and abilities. There is no neat correlation between their taxable activities and their e-literacy.

22.24 The approach to this group therefore stops short of setting a requirement to file online. Instead Lord Carter has proposed measures to encourage those that are e-literate, or who use intermediaries such as tax agents, to file their Self Assessment returns online. The option to submit a return on paper will remain but taxpayers who choose that route will need to file earlier, helping HMRC to spread the processing load.

22.25 Nearly 30% of paper Self Assessment tax returns are currently submitted on substitute forms produced on computers using tax software products and then printed out and submitted by post. The vast majority of the software products can be used to file online. More than 90% of these substitute returns are produced by tax agents.

22.26 Printing and re-keying these returns is a wasteful process that can introduce error into the clean data produced by software. Substitute returns are also more difficult to scan meaning that, even where optical data capture processes are available, manual intervention is frequently necessary. For these reasons Lord Carter recommends that HMRC should stop accepting paper substitute SA returns from 2008.

22.27 The filing period for SA returns is currently 10 months, which is far longer than the OECD average for personal tax returns of 4 months. This can be unhelpful, as taxpayers are less likely to have the relevant information to hand if they complete their return towards the end of the filing period. It can also make enquiries into returns more difficult and stressful as the events during the return period may be less clear in the taxpayer's mind.

22.28 The House of Commons Committee of Public Accounts' report on Filing of Income Tax Self Assessment Returns¹⁰, published in February 2006, suggested that changing filing deadlines could smooth the workflow of processing in HMRC, with

⁷ Different rules may apply for grouped companies

⁸ It is possible that this change may be packaged with the change to the SA enquiry window and implemented before 2010.

⁹ Extensible Business Reporting Language: ICT standard for business financial reporting

¹⁰ <http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmselect/cmpublicacc/681/681.pdf>

benefits for efficiency and accuracy. It also noted that overseas tax authorities typically allow far shorter filing periods than the UK and recommended that, subject to Lord Carter's review, HMRC should explore differential filing dates for paper and electronically filed returns.

22.29 Lord Carter's proposals for Income Tax Self Assessment returns are that:

- the deadline for filing 2007/08, and subsequent, paper returns should be 30 September, following the end of the tax year in April;
- the deadline for filing 2007/08, and subsequent, online returns will should be 30 November, following the end of the tax year in April;
- from 6 April 2008 paper substitute returns will not be accepted for 2007-08 and subsequent years; and
- for 2007/08, and subsequent, returns the enquiry window will be linked to the date the return is filed (this will encourage early filing and give taxpayers certainty sooner).

22.30 The SA payment dates (31 January and 31 July) will not change. The new filing dates will mean that all taxpayers that file on time will know how much they need to pay by 31 January as they will either receive a statement from HMRC before that date or, if they file online, the software will produce an automatic calculation.

Sectors and Groups Affected

22.31 Most businesses whether they are large or small, incorporated or non-incorporated, will, by 2010, be subject to the new requirements. In particular, the new rules will impact immediately on new small businesses that first register for VAT after 31 March 2008. There are up in the region of 230,000 new registrations for VAT each year.

22.32 However, in practice, many businesses will be unaffected by the new requirements because they will already be filing online by the time the requirements apply. In the following tables, the number of "businesses and taxpayers affected" refers to those who will need to modify their behaviour as a result of the proposed changes.

Table 22.1 Estimated number of businesses and taxpayers affected by the new requirements (excludes those that adopt online filing before the measures are implemented)

	Phase One From 2008	Phase Two Additional numbers affected from 2010	Phase Three Additional numbers potentially affected from 2012¹¹
Company Tax Returns Phase two applies to all companies	N/A	1.8 million companies	N/A
VAT Returns Phase one applies to existing traders with turnover > £5.6 million p.a. and new traders Phase two applies to all traders with turnover > £100K Phase three will apply to the remaining VAT traders	0.5 million	0.94 million	0.5 million
PAYE In-Year Forms Phase one – employers with 50 or more employees Phase two applies to small employers.	0.01 million	1.8 million	N/A
Self Assessment Tax Returns Phase one <ul style="list-style-type: none"> • substitutes withdrawn • differential filing dates 	2.4 million	N/A	N/A

Equity and Fairness

22.33 Overall the proposals will affect all taxpayer groups that file CT, VAT, PAYE or SA returns and who are not yet filing online.

22.34 The impact will be greater for businesses that pay CT or VAT as all those businesses will ultimately be required to file returns online and make payment electronically. The proposals will impact sooner upon new small businesses registering

¹¹ Phase three will mandate the remaining VAT traders - those with turnover < £100,000. The aim will be that all traders should be required to file VAT returns online by 2012 but the precise timing will depend on the internet penetration and IT skills within that segment.

for VAT after 31 March 2008, than existing small businesses, as the former will need to file their VAT returns online, and pay electronically, from the outset. However, our research shows that new businesses are more likely to be users of IT¹². The requirement to file online from the outset will also mean that they avoid later transition costs.

22.35 The impact on SA taxpayers (partnerships, individuals and trusts) is less as these groups will still have the option of sending SA paper returns, though they will need to do so by 30 September following the end of the tax year. If they choose to send in a paper return before 30 September, they will incur no cost.

Costs and Benefits

22.36 The changes to the filing dates for SA returns should not cause taxpayers additional costs. The vast majority of employee and pensioner SA taxpayers have all the information they need to complete their returns by the end of July. The few that do not may include provisional figures in their returns if necessary. Self-employed SA taxpayers, or their agents, need to prepare accounts information in order to complete their returns and many may need to do this sooner after the end of the tax year than they are currently accustomed to.

22.37 The ten most popular software products for producing SA substitutes already incorporate online filing functionality and we anticipate that the announcement that substitutes will be withdrawn from 2008 will lead the remaining software producers to incorporate that functionality in their products. We therefore do not anticipate that the withdrawal of substitutes should cause agents to incur significant additional hardware or software costs. (They have to update their software annually in any event).

22.38 The change to the SA filing dates will be a significant change that potentially impacts all SA taxpayers and their agents. Although the costs of completing a tax return should not change it will be essential that the new deadlines are well communicated to all SA taxpayers and we will be working with professional tax agents to achieve as smooth a transition as possible.

22.39 We also recognise that in the first year the new deadlines will pose a significant challenge for tax agents, as they will need to compress the work currently done over 10 months by at least two months. The impact will be greater for those with a high proportion of self employed clients as they will need to ensure that those clients provide their books and records sufficiently early to enable them to complete the accounts work needed to prepare the return.

22.40 Although the costs of preparing accounts and returns should not change we appreciate that agents will incur transitional costs through the need to change their working practices and educate their clients. The consultation section of this assessment seeks views about those transitional costs and how the impact can be minimised.

22.41 The VAT, CT and PAYE proposals will have no effect on those businesses that already file their tax returns online. There is also no effect on those businesses who were planning to switch to online filing voluntarily before the proposed requirements would take effect (since they will not need to change their planned behaviour as a result of the proposed changes).

¹² The 2004 HMCE Business Needs Survey found that 84% of newly registering VAT traders had Internet access compared with 79% of all VAT traders.

22.42 Only those businesses and taxpayers that will start filing online (or start sooner) solely because of the proposed changes are affected. These businesses and taxpayers will see their compliance costs change:

- Online filing offers several advantages when compared with sending in tax returns on paper. These advantages should give ongoing annual savings on compliance costs for the majority of firms who transact online.
- There will be a one-off requirement to spend time registering at the HMRC website and in familiarisation with the system. For anyone with existing access to the internet, this set-up cost should be low, and may be offset by the benefits immediately.
- In a minority of cases, where a business does not have easy access to the Internet, there may be additional costs associated with acquiring and maintaining such access, and with training. HMRC will work with other public organisations and the voluntary sector to ensure that public Internet access, and appropriate support, is available for those who need it.

Benefits

22.43 HMRC estimates the effects as follows:

Economic

22.44 The proposals will result in cost savings to both taxpayers and to Government. More complex returns may be completed quicker as the software only presents the sections of the form that apply to the particular taxpayer, reducing the time needed to work through the form and relevant guidance. Even for simpler returns and forms which will not necessarily be faster to complete on screen than paper, the integral calculation and checking functionality should reduce errors and time spent on double checking tax calculations.

22.45 The use of software will also promote clean data and reduce the amount of time taxpayers have to spend on follow up queries after the form or return has been submitted. Automatic receipt and acceptance notification may also reduce time spent on telephone or other contact to check that a return or form has been received. There will be additional savings on printing or photocopying and postage. Accountants and other intermediaries can expect to see similar savings, which could be passed on to their customers.

Table 22.2 Expected annual benefits for taxpayers who switch to online returns¹³

VAT	<p>Online filing will save the typical trader time and administrative costs worth £5 per return. This is based on an estimated time saving of up to 10 minutes per return from reduced checking and error correction. The majority of traders render returns quarterly and will therefore save £20 per year</p> <p>Traders who file online must pay electronically. Most traders will benefit from up to 7 extra calendar days to file their return and make their payment (with a further 3 for those that pay by direct debit) and this may provide them with a small additional cash flow benefit</p> <p>These payment benefits do not apply to traders using the Annual Accounting Scheme or those that are required to make payments on account</p>
Corporation Tax	<p>Most accountants should save around £20 per return through time, printing or photocopying and postage savings. The small minority of companies who do not use agents will save slightly less</p>
PAYE	<p>Employers, or their intermediaries, will save approximately £3 per P45 or P46. This is based on an estimated time saving of around 5 minutes per form from reduced checking, error correction and filing. This could increase to £5 if the resultant coding notices are automatically processed by the employer's payroll system</p>
Income Tax Self Assessment (switching from substitute returns to online filing)	<p>Over 90% of substitute returns are filed by agents. Online filing will save those agents (and hence taxpayers) between £18 and £25 per return for simple returns, rising to £90 for the more complex¹⁴</p>

22.46 These estimates of savings assume that for taxpayers and businesses, who complete their own returns, time is valued at £30 per hour and that agents' time is charged out at least £60 per hour.

¹³ These figures represent HMRC best assessment of the average benefit across all those who switch to online services as a result of these proposals. The precise impact will vary according to individual circumstances. Comments on these estimates are invited in the consultation section of this assessment.

¹⁴ Figures provided by MYOB (software providers) from a survey of their clients.

Table 22.3 Expected total benefit to taxpayers¹⁵

	Taxpayers Affected	Total Annual Benefit From 2012
VAT	2 million	£42 million
Corporation Tax	1.8 million	£36 million
PAYE in Year	1.8 million employers filing 20.8 million forms	£62-104 million
Income Tax Self Assessment (Switching from Substitute Returns to Online Filing)	1.4 million	£25 - 35 million
Income Tax Self Assessment (Switching from Standard Returns to Online Filing – Triggered by Differential Filing Dates)	1 million	£10 – 30 million

22.47 We estimate that the total benefit for all taxpayers and businesses affected will be between £175m and £247m p.a. from 2012 / 13. The estimated total benefits for business will be between £158m and £215m p.a. from 2012 / 13

22.48 In addition to the direct benefits to taxpayers, there are savings to Government in terms of processing and administrative costs. Part of these savings will be used to fund improvements to the service offered by HMRC to taxpayers.

22.49 Estimated savings to Government: climbing to £59 million per year by 2014 / 15.

Social

22.50 There are no major social impacts, although the proposals will have a positive impact on levels of education and skills, associated with the increasing use of online services amongst both businesses and private taxpayers.

22.51 Indirectly, the efficiency savings for Government will deliver the potential for investment elsewhere, with associated benefits for society.

Environmental

22.52 There may be a small net benefit to the environment caused by the move from paper-based systems to electronic. The proposals will eliminate the need for a

¹⁵ The total benefit is calculated by multiplying the number of taxpayers switching to online returns by the average benefit per taxpayer (from the previous table). All figures are HMRC's best estimates.

significant number of paper forms per year. They may also have a small positive impact on CO2 emissions through the reduced use of postal delivery.

Costs

Economic

22.53 The vast majority of taxpayers who switch to online returns will not incur any significant costs. Anyone who has existing access to the Internet, and the associated skills, will need to spend a small amount of time registering to use HMRC online services (about half an hour per taxpayer or tax agent). Those without easy access will need to obtain it, but there are various ways of doing that and HMRC will be working with taxpayers to ensure that a range of options are available, and that those options are as cost-effective as possible.

22.54 Free local Internet access is already available through UK Online and LearnDirect centres and HMRC will work with public and voluntary organisations to ensure that appropriate support is available.

Table 22.4 Estimated Costs to Taxpayers (one-off)¹⁶

Those using an agent (nearly all of whom have Internet access)	Negligible
Those not using an agent but who have Internet access	0.5 hours @ £30 per hour = £15
Those not using an agent and who have no Internet access	£100 (to cover, say, 2-3 hours training.)

Table 22.5 Total Estimated Costs (one-off)

	Taxpayers Affected	Total Costs
VAT	2 million	£23 million
Corporation Tax	1.8 million	£6 million
PAYE	1.8 million	£17 million
Income Tax Self Assessment (switching from substitute returns to online)	1.4 million	Negligible
Income Tax Self Assessment (switching from standard paper returns to online triggered by differential filing dates)	1 million	£10 million

22.55 The costs shown above do not include any transitional costs for agents from the need to change working practices to adapt to the new filing dates. We anticipate that

¹⁶ The costs shown here are HMRC best estimates of the typical or average effect. Costs may vary according to individual circumstances. The total cost is calculated by multiplying the average cost figures in this table by the respective number of taxpayers switching to online returns as a result of these proposals.

the costs will be spread over the two years leading up to implementation and that the cost per client will not be significant but agents views on this are sought in the consultation section of this assessment.

22.56 Once these one-off set-up costs have been incurred, the ongoing cost of submitting returns and forms will be less than the paper equivalent. Hence the ongoing effects are included in the benefits section as a compliance cost saving.

22.57 In addition to the set-up costs for taxpayers, the Government will incur costs associated with the transition in providing support services and advice throughout the process. These costs include publicity and other communications relating to the new SA filing deadlines but exclude the investment in online services infrastructure referred to in paragraph 22.3.

22.58 Costs to Government: £36 million set-up + £3 million p.a. from 2012 / 13.

Social

22.59 There are unlikely to be any significant social costs.

22.60 The risk of cyber-fraud is judged to be minimal but HMRC recognises that security is a concern for many people. We will continue to ensure that our services use industry standard encryption and that clear information is provided to customers about the security measures built into the services and what they should do to protect themselves.

22.61 Public access to the internet may be more limited in rural areas, for people with disabilities, for older people and/or for people who do not have English as their first language. HMRC will be addressing these risks by monitoring the availability of free public internet access and working with other Government departments as necessary. We will also provide information about web translation services, which can be used in conjunction with our online services.

Environmental

22.62 There may be a net benefit to the environment as a result of these changes as outlined above. There are no significant adverse impacts.

Small Firms Impact Test

22.63 Small businesses will be affected by these proposals but many small businesses have already made the move to submit returns online. Small businesses that have employees are benefiting from the financial incentives offered to encourage them to file online and around 900,000 (over 60%) sent their 2004-05 returns online although there was no requirement for them to do so.

22.64 Most incorporated businesses, both large and small, use intermediaries to file their company tax returns so the move to online filing is unlikely to present them with any major difficulty. Non-incorporated small businesses will still have the option to file Self Assessment paper returns providing that they do so by 30 September.

22.65 The main impact will be upon small VAT registered businesses that have an annual turnover greater than £100,000 as they will be required to file online from 2010 and many do not currently use intermediaries. Research shows that the majority are already users of IT but it is recognised that there will be additional costs for those who

are not. Those businesses will need help and support in identifying the options open to them and making the changeover. However, adopting IT may produce wider business benefits such as streamlined accounting and invoicing and improved access to information, customers and new markets.

22.66 The responses to the consultation with small businesses that was launched by HMRC in March 2005 indicate that small businesses are willing to conduct business with HMRC electronically provided that online services are reliable, easy to access and simple to use.

Competition Assessment

22.67 These measures introduce a small set-up cost followed by long-term savings. Because the costs per business are relatively low, we do not anticipate any major effects on competition or competitiveness, however there will be a differential effect on different types of business, particularly in the short term, as set out below.

22.68 The Regulatory Impact Assessment competition filter test has been applied. The proposals apply across the board to all businesses and do not affect any particular markets. However, the costs (and benefits) will fall on those businesses which do not currently file online, and that means that some categories will be affected more than others. Small businesses, new businesses and businesses not using agents are more likely to be affected than larger firms. New firms registering for VAT between April 2008 and March 2010 may be disadvantaged in the short term because they will be required to use online services right from the start, at a time when their resources may be targeted elsewhere.

22.69 We will be looking to see how best to support those businesses and minimise the impact upon them. This possible disadvantage for new firms will cease for most by April 2010 when all traders with an annual turnover in excess of £100,000 will be required to file their VAT returns online. In certain sectors (the IT industry being an obvious one) firms are more likely to have access to online services, even when they are setting up, so would not be adversely affected.

Enforcement, Sanctions and Monitoring

22.70 There are already provisions in place to secure compliance with the filing and payment requirements. There are:

- financial penalties for failure to file returns by the filing date; and
- financial sanctions for failure to make payment on the due dates.

22.71 Under these new proposals there is no intention to make any changes to those existing compliance provisions, except the enquiry window for SA and company tax returns. The Review of HMRC Powers¹⁷ is looking at the whole range of HMRC powers relating to inspections and enquiries and it is possible that there will be more radical changes to the way HMRC audits returns. Lord Carter's report suggests that his proposal for changes to the enquiry window should not preclude that but that any new rules relating to the timing of queries into returns should be designed with the same aim in mind: to encourage early filing by linking the date at which the taxpayer has certainty and knows their return will not be queried, to the date on which their return was submitted.

¹⁷ HM Revenue & Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards

22.72 We will be consulting businesses about the best ways to enforce the new requirements to file online and pay electronically. The two main options are to reject paper returns or forms, and non electronic payments, or to accept them but charge some form of penalty for failure to file online or pay electronically. The first option could use the existing sanctions for late filing or payment to enforce the new requirements – as taxpayers that did not resubmit their return or payment by the appropriate means by the deadline would incur the late filing /payment sanction.

22.73 This partial impact assessment is just the start of a collaborative work with all the groups who will be affected by the proposed changes. We would expect to have ongoing meetings and discussions over the next two years with representatives of all the groups affected by the changes including: businesses both large and small; individuals; trusts; agents and payroll providers; and IT and software providers.

22.74 The main proposals will be introduced, subject to the right “building blocks” being in place, between April 2008 and April 2010. During that period the success of the proposals will be constantly monitored and evaluated so that any necessary improvements can be made to communications, processes and support. The cost benefit analysis will be subject to HMRC post implementation review programme and reviewed as soon as it is appropriate to do so after introduction of the changes. Each tax will be considered separately.

22.75 The review will focus on take-up rates, costs and benefits - confirming in each case whether the predicted effects were realised (both for taxpayers and for the Government). Any indirect effects (such as a reduction in errors on tax returns) will also be reviewed where practicable. HMRC will consider in due course how best to consult businesses and other taxpayers to inform this review.

Summary and Recommendation

22.76 In order to capture the benefits of online filing and payment for both business and HMRC we believe it is necessary to introduce legislative measures in order to increase use of online services. However, there are a number of areas where input is sought around the practicalities of introducing the changes. In particular, it would be helpful to understand:

- What are the particular issues for new businesses and what support will they need?
- What are the issues for intermediaries such as agents and payroll providers and how can we best work with them to minimise the impact of the proposed changes and implement them successfully? What transitional costs do agents anticipate from the need to change their working practices and how can these be minimised?
- Are the transitional costs for businesses and taxpayers realistic?
- Are the time and resource savings estimated for taxpayers, businesses, and agents realistic? Are there other quantifiable, associated savings?
- What are the particular issues for software providers and how can we best work with them to implement the changes successfully?
- What issues does XBRL raise for business and software providers?

- How can the new requirements best be communicated to all groups affected, and in particular to the smallest businesses and individuals who may not use intermediaries to complete their returns?
- What would be the best way to enforce the new requirements to file online and pay electronically.

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