Treasury Committee
Inquiry into the fundamental principles of tax policy
Written evidence

1. Executive summary

1.1. 'Tax policy' covers a wide spectrum: international to local taxation (including devolved administration variations); the large corporate body to the small sole trader; the high net worth individual to the low-income taxpayer or benefits claimant. All government policy should consider whether tax is an issue and be designed accordingly.

1.2. The tax system should be progressive across the board, not just in terms of income tax rates, but also wealth and consumption taxes.

1.3. We generally recommend aligning rules and definitions, but only where it makes sense to do so in terms of simplifying compliance, minimising distortions and saving administrative costs all round. Tax policy must always be workable by design; otherwise it is bound to fail or descend into complexity (in which case it is often the taxpayer who is willing to comply but inadvertently gets it wrong who suffers the consequences). We hope that in due course the Office for Tax Simplification will be able to play a role in such further development of the system.

1.4. Thorough consultation in advance of policy implementation, where possible, is imperative. Government should over-compensate for the likely inability of the unrepresented and low-

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income taxpayer to speak for himself, by proactively seeking views of charities which seek to represent them. LITRG can assist by co-ordinating those efforts, particularly where tax non-specialist charities need to be consulted.

1.5. Each year, a proportion of the Finance Bill and debates should be devoted to addressing problems of the low-income population. We suggest a HM Treasury, HMRC and voluntary sector working group is established to identify key issues, linking also to the Treasury Committee.

1.6. In designing tax policy, simplicity of its administration, communication of its meaning and clarity of the law itself should be paramount. If complexity cannot be designed out of the system, it should remain hidden behind properly resourced customer service, whether delivered through the civil service or an appropriately funded voluntary sector.

1.7. Tax policy can support growth by linking with welfare benefits policy and its aims to encourage more people off benefits and into work. It can also provide reliefs for those who become ill or disabled while in work to help keep them in work and off benefits.

1.8. Tax policy can also encourage self-employment with flexible payment arrangements and relief for losses and capital investment, particularly in the early years of a new trade. But this will fail if welfare benefits policy does not similarly recognise these issues.

1.9. In answer to question five, though by no means an exhaustive list, we have identified below a number of distortions in the current system. These include: pensioner problems (giving an example of where policy aimed at more wealthy individuals impacts on those of much lesser means); the confusion created through different rules for tax and National Insurance; and the uncomfortable relationship between independent taxation and household assessment of welfare benefits. In conclusion, these examples illustrate that policy needs to be continually reviewed to check it remains valid; and that different definitions create confusion for the individual which in turn argues for a more cohesive system, not just within tax but looking across to associated fiscal (and sometimes even non-fiscal) policy.

2. About us

2.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes.

2.2. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3. Our response to the inquiry's questions

3.1. *What are the key principles which should underlie tax policy?*

What is included in the term 'tax policy'?

3.1.1. Fundamental to this inquiry is firstly to consider what is meant by 'tax policy'. The term could encompass many things: European taxes such as VAT; other indirect taxes such as excise duties; direct taxes such as corporation tax and income tax; social security (National Insurance) contributions; taxes on wealth such as stamp duties, inheritance tax, capital gains tax; local and devolved taxes; and perhaps even other items, such as student loan repayments, which are collected via the tax system.

3.1.2. The overall impact of tax on a person's or entity's situation cannot be considered without looking at this entire spectrum. In general, alignment of rules and definitions across the different duties creates simplicity; but as we have said during the review of HMRC Powers over recent years, alignment for its own sake should not be not be pushed through at the expense of fairness or where it makes sense to make exceptions.

A progressive system

3.1.3. The tax system should be progressive across the board, not just in terms of income tax rates, but also wealth and consumption taxes.

Targeted support

3.1.4. One of the key questions is whether the tax system is the best means of offering support where, for example, the Government wishes to encourage growth or target help at a certain group. Generally, we think the tax system can be useful in either being the key means of delivering such policy intentions or supporting their delivery (see comments on welfare benefits in answer to question three below). But inevitably, the more detailed the rules are in offering reliefs and exemptions, the greater their complexity. There is therefore a balance to be struck.

Thorough consultation in advance, where possible

3.1.5. The consultation process generally ensures that everyone who is in the loop has an opportunity to respond to any proposals. But what about those who are not in the loop who may be equally affected by the changes? How does government hear their voice?

3.1.6. As we noted in our response[1] to the consultation *'Tax policy making: a new approach'* last summer, we believe that LITRG (in its position looking at how tax policy cuts across to other policy) has a special role here in helping government, and indeed the Committee, to ensure that the views of everyone affected are gathered. LITRG is uniquely placed to play a co-

[1] See http://www.litrg.org.uk/submissions/2010/tax-policy-making

ordinating role with 'tax non-specialist' charities to make sure that tax issues are considered by them where necessary.

3.1.7. We also recommended in that submission that every year a part of the Finance Bill debate (and space for clauses in the Bill itself) should be devoted to solving some of the problems of the unrepresented – various examples of which we give in our answer to question five below.

3.1.8. In this respect, we believe that the Government needs to over-compensate for the low-income population by making a special effort to gather views and analyse their needs in advance of policy decisions. There is a perception that if there are 50,000 low-income people affected by a tax issue then this is likely to be regarded as 'small' by HMRC and the Treasury and not deserving of time being spent compared to if those 50,000 were from a high-income sector. We therefore favour creation of a special low-income team in the Treasury linking to HMRC's Individuals Customer Directorate and the specialised tax voluntary sector to redress the balance. It would be helpful if there were a member of staff working for the Treasury Committee who could take part in this work.

Clarity of the law and simplicity of administration

3.1.9. We comment further below under the fourth question, but generally a key principle of tax policy design should be simplicity of administration.

3.1.10. Moreover, we believe the law itself should be as clear as possible and its expansion or interpretation through HMRC guidance kept to a minimum. A straightforward rate structure would, for example, go a long way towards simplification. One example is the tortuous 10% starting rate on savings which because of its complexity is little known, poorly understood and probably claimed by only a few of those who are entitled. While at present the role of the Office for Tax Simplification is to look only at the simplification of the present system, we hope that in due course they would have the resources to enable them to play a part in the development of the system.

3.2. ***How can tax policy best support growth?***

3.2.1. As we note in our answer to question three below, tax policy should be joined up with welfare and benefits policy. Key objectives in so doing are to:

- ensure that the fiscal system recognises the entire financial situation of an individual who is both a taxpayer and a claimant;
- ensure the tax system supports those who become ill or disabled to remain in work, perhaps for example by offering reliefs so that people can re-train where they are unable to continue in an existing role;
- simplify the rules, and provide incentives, for new businesses to encourage those wishing to move into self employment; and

- provide flexible tax payment options tailored to business needs.

3.2.2. In terms of the third bullet above, the necessity for joined-up policy has been recently illustrated in the proposed system of the Universal Credit. We have pointed out that the initial idea for the self-employed to be deemed to earn the equivalent of the National Minimum Wage, even when their business is yielding no profit, is divisive. Moreover, this would be a retrograde step from the current tax credits rules which basically follow the tax system and allow for the likelihood of losses and capital outlay, particularly in the early years of a new business.

3.3. ***To what extent should the tax system be structured to support other specific policy goals?***

Welfare and benefits

3.3.1. In launching the inquiry, the Committee noted:

> *'The Mirrlees Review, published by the IFS, argues that the tax system should be considered as a whole with the benefit system, seek neutrality, and achieve progressivity as efficiently as possible.'*

3.3.2. One of LITRG's key principles has always been that the tax system should support, not detract from, the delivery of welfare. In our work, we continually urge policy makers to look across all tax and welfare systems and assess the impact of any proposed measures on each individual's or household's financial situation taken as a whole. It is vital to ensure that the beneficial effects of a measure designed to help an individual are not countered by existing rules elsewhere in the tax/benefits system, simply because policy makers had failed to look across the whole spectrum.

Joined-up policy and legislation

3.3.3. Furthermore, we aim to look at other policy changes and see how they might be joined up with tax policy (rather than simply looking at the impact of tax policy on other areas). In so doing, we can help to identify ways of simplifying policy across the board. One recent example of this was where we commented on proposed changes to the National Minimum Wage (NMW) legislation in respect of travel expenses, suggesting the NMW Regulations should be aligned with the income tax definition; a recommendation which was accepted and implemented from January 2011[1].

3.3.4. A further example is our work on independent living[2], identifying the tax impacts on people who are enabled, through direct payments, to employ carers or household help.

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[1] See paragraph 3.4.2 of our consultation response - http://www.litrg.org.uk/submissions/2010/travel-expenses-nmw

[2] See our 2008 report – *'Independent living, direct payments and the tax system'* http://www.litrg.org.uk/reports/2008/independent-living-direct-payments-and-the-tax-system

3.3.5. We therefore urge that wider government policy should have a 'tax check' to ensure there are not unforeseen tax consequences.

3.4. ***How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?***

3.4.1. We believe this is important and should be considered at the earliest stages of policy design. A tax matter might be complex, but compliance with the rules should be made simple for the taxpayer, so as to reduce administration costs for HMRC and foster good customer relations.

3.4.2. Any complexity should therefore be hidden so far as possible, by giving taxpayers clear instructions how to comply. Therefore, successful tax policy should have its communication strategy to the taxpayer inbuilt; or, where a change is rushed through to counter some perceived mischief, there should be time devoted thereafter to such considerations.

3.5. ***Are there aspects of the current tax system which are particularly distorting?***

3.5.1. In its work, LITRG has identified many areas of distortion. There are areas where the system is illogical and unnecessarily complex.

Pensions

3.5.2. For example, we have recently been reviewing the issue of small pensions and those who are permitted, subject to certain restrictions, to 'trivially commute' their entire pension pot as a partially-taxed, partially tax-free lump sum. This is one area where a change aimed at wealthier taxpayers, to reduce the total pensions lifetime allowance, could have affected those, generally lower income, taxpayers who have only accrued small pensions. This was because the limit on those pensions which could be trivially commuted was defined by reference to the lifetime allowance.

3.5.3. Thankfully, that link is to be removed; but idiosyncrasies remain such as the need to commute a number of trivial pensions within 12 months of the first such commutation. We have been unable to determine clearly the rationale for such a restriction, which seems an unnecessary complication where there is already a monetary limit on the overall amount which can be encashed. And indeed the same restriction does not apply to other commutations, such as those which are non-trivial, or trivial commutations arising on winding up or death. It can lead to distortions by, for example:

- forcing the encashment of all policies within a short space of time which might not make financial sense for the taxpayer; or
- forcing the purchase of an annuity in the (not uncommon) situation of a forgotten small pension pot coming to light after the 12 month window has expired.

Thresholds

3.5.4. Distortions can be created where there are differences in thresholds. For example, income tax starts to be paid at a different point than National Insurance contributions which in turn differ from tax credits and benefits taper thresholds. Moreover, someone working at National Minimum Wage rates and living below the poverty line can be liable to tax and National Insurance.

3.5.5. These cross-cutting issues are continually at the forefront of LITRG's work. But even though these considerations are now coming to the attention of the Government, for example through the review of benefits and creation of the new Universal Credit, issues of concern remain.

3.5.6. For example, with the Government's policy of gradually increasing the personal tax allowance to £10,000, it does not seem that the knock-on issue of the higher personal allowances for pensioners has been considered, which continue to be uprated only for inflation. We have urged that the policy be considered as a matter of urgency[1].

Tax and National Insurance differences

3.5.7. Recently, increased attention has been focused on possible alignment, or even merger, of income tax and National Insurance. We agree that there is merit in reviewing the two systems to see where consistency can be achieved.

3.5.8. For example, where an employee is not reimbursed employment-related expenses by their employer, such as for business mileage, they can make a claim against their income tax liability for tax relief on the value (although many may not do so because they are not aware they can). However, a similar claim is not available for National Insurance.

Independent taxation versus household assessment of benefits

3.5.9. Following on from our response to question three above, one of the obstacles to taking an accurate overview of tax policy interactions with welfare benefits is the conflict between household assessment of tax credits and benefits as against independent taxation; and indeed the various definitions of a 'couple' for different purposes. National Insurance in some ways straddles the two, with the possibility of claiming benefits by reference to another's contributions or even transferring credits to someone else in certain situations (see for example the recent consultation on transferring NI credits to another family member where the child benefit claimant goes out to work[2]). This is an area of tax policy which is indeed overdue a thorough review.

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[1] See http://www.litrg.org.uk/News/2010/tax-policy-pensioners

[2] See http://www.litrg.org.uk/submissions/2010/ni-credit-changes

Policy lessons to be learnt from current distortions in the system

3.5.10. From the example of trivial pension commutations above, we conclude that it would be useful to ensure reliefs are continually reviewed for efficacy, that the parameters are still right, and to see if there are any rules or restrictions which detract from the economic benefits of the relief.

3.5.11. Furthermore, we have illustrated how failure to align definitions, rules and procedures creates confusion. There are myriad examples of such lack of alignment in the wording of the law, where different terms and language are used to describe basically the same concept. Also, the same individual may have to supply the same information to multiple government departments, or multiple silos within a single department, and in varying ways depending on which rules they are complying with.

3.5.12. A single financial transaction can result in income which is taxable but disregarded for tax credits and possibly treated as capital for assessment of welfare benefits. How much simpler life could be if these issues were reviewed and aligned if possible, and if in future policymakers were to consider matters in the round when initiating change.

LITRG
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