

# 13. Tax simplification

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## Summary

- The government has reaffirmed its commitment to simplify the tax system, but attempts by this and previous governments to deliver real and long-lasting reductions in complexity have usually come to nothing and the volume of tax legislation has grown inexorably.
- The rewrite of direct tax legislation, initiated under the last Conservative government and still in progress, uses simpler language but at much greater length and without resolving any of the underlying complexity in the legislation.
- The abolition of buildings allowances, the reform of capital gains tax and proposals for adopting simpler ‘principles-based’ anti-avoidance legislation are three measures that offer the prospect for some simplification of existing rules.
- Each proposal, however, has met with opposition. In the first two cases, those adversely affected by the proposals have objected. The third case has prompted concerns that it will create uncertainty and confer too much discretion on HM Revenue & Customs. Each proposal illustrates a variety of trade-offs that have to be made between simplicity and other legitimate aims of particular measures.
- Real simplification is difficult to achieve without more fundamental consideration of what, who and how we tax. Tackling complexity requires that we recognise what is complex and why, and focus on what can sensibly be done about it.
- In this respect, the government’s approach of identifying particular elements of the tax system for review is a useful start. Ultimately, however, government must be clear as to its policy goals. One can then judge whether it is its goals that are complicated – possibly too complicated – or just its methods.

## 13.1 Introduction

Tax simplification is in the air again. Building on a number of announcements in its 2007 Budget to simplify both the personal and business tax regimes, the government reaffirmed its ‘commitment to tax simplification’ in its 2007 Pre-Budget Report by announcing three reviews to consider:

- how to simplify VAT rules and administration in the UK and the EU;
- how anti-avoidance legislation can best meet the aims of simplicity and revenue protection; and
- how to simplify the corporation tax rules for related companies.

HM Revenue & Customs has followed up each of those announced reviews by holding meetings with interested parties and publishing material detailing areas where there is scope for future simplification and, in one case (anti-avoidance), publishing a consultative document with illustrative ‘general principles’ draft legislation. Consultative bodies have been encouraged to submit lists of ‘quick win’ simplification suggestions. After 10 years of a Chancellor who was not noted for his concern for simplifying the tax system, a tax-simplifying Budget offers a new Chancellor, with little room for manoeuvre on revenue or policy, an opportunity to make his name in ways that may be remembered.

A background to the simplification process is given in Section 13.2, while Section 13.3 gives some recent examples of simplifications which, due to their impact, have been met with a mixed reaction from those affected. Section 13.4 concludes.

## 13.2 A 10-yearly simplification cycle?

The complaint that tax law is too complex is not new. Members of Parliament urged the then Chancellor of the Exchequer William Gladstone, in a Parliamentary debate in 1853, to see that income tax legislation was made intelligible to everyone, even those who had not benefited from a legal education. He replied that:

To bring the construction of these laws within the reach of [everyone is] no doubt extremely desirable, but far from being easy ... the nature of property ... and its very complicated forms [render] it almost impossible to deal with it for the purpose of the income tax in a very simple manner.

In 1981, the Presiding Special Commissioner referred to Gladstone’s statement and added that ‘the plea today is that it would be some advance if laws of this kind were intelligible to those who *have* received a legal education’.

More recently, tax simplification is a topic that has commanded attention at broadly 10-yearly intervals – roughly the same intervals as the major restructuring of capital gains tax (CGT). Consider this:

The last Finance Act has created a crescendo of dissatisfaction in the tax world. It is one of the longest in British fiscal history and it is, essentially, about nothing. It leaves the system no better, and little different; only more complicated.

That was John Kay in his valedictory speech as Director of IFS in 1986.<sup>1</sup> And then:

This is the year of simplification of tax legislation.... There is nothing new in complaining about the complexity of tax legislation. Every generation does it.

That was John Avery Jones, a member (and subsequently chairman) of the IFS Tax Law Review Committee, in 1996.<sup>2</sup> This last comment followed section 160 of the Finance Act 1995, which required that ‘The Inland Revenue shall prepare and present to Treasury Ministers a report on tax simplification’. The report was published in December 1995 and

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<sup>1</sup> Page 2 of J. A. Kay, ‘Tax reform in context: a strategy for the 1990s’, *Fiscal Studies*, 1986, 7(4): 1–17.

<sup>2</sup> Page 63 of J. Avery Jones, ‘Tax law: rules or principles?’, *Fiscal Studies*, 1996, 17(3): 63–89.

entitled *The Path to Tax Simplification*. In the event, the path pursued was that of the Tax Law Rewrite, but as Avery Jones commented at the time:<sup>3</sup>

My real objection to rewriting is that I do not find much of a connection between the causes of [complexity] and the proposed solution. The solution seems to me to be an implied acceptance that nothing can be done to remove the real causes of complexity which are deeply rooted in our whole legal culture. If you start with 6,000 pages of gobbledegook, you will end up with a number of pages ... of easier-to-read legislation, but will we all say that this is the end of complexity?

Since Kay's speech in 1986, Finance Acts on average have continued to expand<sup>4</sup> and, as Avery Jones predicted, we have discovered that expressing complex concepts in plain English does nothing to simplify the concepts themselves. The income tax legislation may have been unbundled from its traditional legal form and put in a more logical order, but the complexity of language has been replaced by the complexity of legislative volume as more words (albeit simpler ones) have been required to preserve precision. Length alone can be a source of complexity, reflecting the ease (or difficulty) with which it is possible to identify and comprehend relevant material and how much of it must be consulted to find the answer to particular issues.

The first consolidation of income tax in 1918 produced an Act of 177 pages. The 1952 consolidation Act was 687 pages and that of 1970 1,297 pages. The consolidation of 1988 with the 1990 consolidation of capital allowances produced 2,796 pages. By 1995, primary legislation on income tax, corporation tax and CGT had grown by 253% since 1970 (from 1,297 to 4,580 pages) and secondary legislation by 744% (from 171 to 1,444 pages).<sup>5</sup> The draftsman of the first rewrite Act – the Capital Allowances Act 2001 – commented in 1996 that:<sup>6</sup>

It has been calculated [by Avery Jones] that this represents a compound growth rate of nearly 6% per annum since 1970, over 8% since 1988, and over 12% since 1992. ... You only have to project these figures into the future to see that things are getting completely out of hand. At these rates of growth in five years time, we would have, depending on what rate of growth you project, 8,000, 9,000, or 10,700 pages. If the legislation continued to grow at a similar rate for a further five years the figures become truly frightening. We could be looking at 10,600, 13,500 or 19,000 pages of tax legislation in ten years time.

The rewrite of income tax alone has taken four Acts of increasing length. Two (possibly three) Acts will follow shortly to rewrite corporation tax and to deal with the residual elements of the Income and Corporation Taxes Act 1988. It is anticipated that the first corporation tax rewrite Act will be the longest single piece of legislation ever put before

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<sup>3</sup> Page 66 of Avery Jones, op. cit. See also page 2:1 of M. Gammie, *Tax Simplification: Right Path or Dead End?*, Canadian Tax Foundation, Report of Proceedings of the 47<sup>th</sup> Tax Conference (the answer was dead end).

<sup>4</sup> The annotated 1986 Finance Act produced for members of the Chartered Institute of Taxation was 297 pages in length. This was exceeded in 6 of the following 10 years to 1996 and in every year since 1997.

<sup>5</sup> See table B in *The Path to Tax Simplification*.

<sup>6</sup> Sellers, 'The Inland Revenue Tax Law Simplification Project', an address to the Statute Law Society on 19 October 1996, *The Quarterly Record*, July 1997, page 208.

Parliament. In 1995, primary and secondary legislation on income tax, corporation tax and CGT ran to 3,856 pages in Butterworths Tax Handbooks and in 2007 it covered 6,564 pages.<sup>7</sup>

### 13.3 Recent ‘simplifications’ in practice

The growth in legislation is symptomatic of the complexity of the underlying concepts that need to be explained. Without any simplification of those underlying concepts – what it is we are trying to tax (the choice of tax base) and the tax structure (tax rates and taxable units)<sup>8</sup> – the achievements in terms of tax simplification are likely to be small, as the Tax Law Rewrite has shown. We can welcome any simplification, however small, but we should be careful to recognise precisely what simplification has really been achieved and at what price. Three examples will serve to illustrate the point.

#### Capital allowances for commercial buildings

A frequent request by business and professional organisations to governments of all complexions over several years has been for the simplification of the UK’s system of depreciation (capital) allowances for industrial buildings and their extension to all commercial buildings. None envisaged the abolition of buildings allowances, but this is exactly what the current government did (in part to simplify the system and in part to pay for the reduction in corporation tax from 30% to 28%).

Those who have lost the benefit of the allowances have not welcomed the simplification in their tax computations, but have complained that paying 28% of something to the government is worse than paying 30% of nothing. This is not surprising. The increased revenue raised by abolishing specific tax allowances may have been largely returned to the corporate sector but, inevitably, there was a mismatch between those who saw their allowances reduced and others who benefited from a reduction in the tax rate. When the government undertakes simplification in the face of this expected response from the losers, it presumably does so in the belief that the additional revenue and cuts in compliance costs for the winners make the reform worthwhile.

The more fundamental problem with this ‘simplification’ is that buildings have not ceased to depreciate and it is still thought appropriate to take account of depreciation in computing business profits. While governments have allowed certain buildings to be depreciated year by year, the computation of business profits does not usually take account of the yearly appreciation in land values. The solution that has been adopted has not been to compute profits for tax purposes more accurately, which could involve more complex calculations, but to adopt a pragmatic but potentially more arbitrary solution to arrive at a more easily computed figure of taxable profits and charge tax at a lower rate. The outcome may be a genuinely simpler system but one that does not necessarily achieve the government’s other

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<sup>7</sup> Pages of Butterworths are not directly comparable to the previous figures, which are based on the number of pages in the Acts. If, however, 3,856 pages of Butterworths represented 6,024 pages of legislation in 1995, 6,564 pages in 2007 translates into 10,250 pages of legislation.

<sup>8</sup> In this respect, the introduction of income-splitting rules for family businesses – an outcome of the choice of taxable family unit – will inevitably complicate rather than simplify the taxation of those businesses.

stated policy objectives in terms of the overall fairness and efficiency of the business tax system.

## **Capital gains tax**

The latest proposed reform to CGT is described in detail in Chapter 10. Broadly, however, we are set to have come almost full circle in 2008 to return to a system that broadly corresponds to that introduced in 1965. IFS was created partly in exasperation at the way CGT was designed in the first place, and John Kay, when IFS Director, memorably remarked that the taxation of capital gains was notable for the half-baked attempts to reform it at 10-yearly intervals.

The 1965 version taxed capital gains but at a significantly lower rate than ordinary investment income.<sup>9</sup> Ultimately, however, the tax fell foul of inflation, leading to the various 1980s versions of indexation, which were then replaced by taper relief.<sup>10</sup>

Nigel Lawson thought he had resolved the differential between income tax and CGT rates in 1988 by taxing indexed gains at income tax rates, but the subsequent introduction of taper relief announced in the March 1998 Budget (for business assets especially) produced a lower rate at some complexity in what the government claimed was an attempt to tackle ‘short-termism’ among investors and to promote innovation and enterprise. As such, the introduction of taper relief substituted the complexity of taper relief for the complexity of indexation and did nothing to resolve the demands for simplification evident in the review of CGT that had preceded the change. Indeed, an inevitable complexity of CGT, especially for fungible assets such as shares, is the need to match acquisitions with disposals and keep track of acquisition costs. The realisations basis of the tax – taxing only on a disposal of an asset – avoids the greater complication of taxing on accruals and any system of inflation adjustment or taper is liable to complicate rather than simplify the system.

The abolition of taper relief (and the accrued indexation for pre-1998 assets) that was announced in the October 2007 Pre-Budget Report almost 10 years after its introduction reverts to a simpler system, ironically as inflation is re-emerging as a concern. As we would expect, those who will pay tax on business assets at 18% rather than 10% (or even 5%) have not thanked the Chancellor for a simpler computation.

In part, the protests at this ‘simplification’ arise from a popular perception that changes to CGT operate retrospectively, taxing gains that have accrued in the expectation of, for example, a 10% tax at an 18% rate. From the government’s perspective, taxpayers who have chosen to postpone paying tax until a later date take the risk that tax rates may change. As it is, by announcing the reform six months in advance, the government has offered some taxpayers the opportunity to realise business assets and pay tax early at the lower rate. Others with less easily realised business assets – and those who choose not to realise their gains – will pay tax later at a rate that, in the absence of further reform, will be higher. And with no adjustment for inflation, the effective tax rate for long-term holders of assets will be higher

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<sup>9</sup> A rate of 30% compared with rates of up to 98% on investment income until 1979.

<sup>10</sup> Described by the author at the IFS post-Budget conference as a reform that had not even been half baked.

than the headline rate, subject to some offset for the deferral of their tax liability until disposal.

There seems little doubt that the post-taper post-indexation system of CGT will be simpler. As the history shows, however, taxing capital gains is one area of the tax system that it is difficult to get right. It remains to be seen whether a simpler system will stand the test of time any better than its predecessors.

## Anti-avoidance in financial products

A final claimed example of tax simplification is found in the recent publication of a joint Treasury and Revenue consultation document on a *Principles-Based Approach to Financial Products Avoidance*.<sup>11</sup> This proposes to replace many pages of complex corporate anti-avoidance legislation with much shorter legislation that will express two basic principles. The first (which will be applied only to companies and not individuals) is that a return designed to be economically equivalent to interest should be taxed in the same way as interest. The second is that receipts which are derived from a right to receive income and which do not involve any loss of capital are economic substitutes for income and are to be treated for tax purposes as income. As broad expressions of principle, these may well command support, although one might wonder why a return has to be ‘designed’ to be economically equivalent to interest before it is taxed as interest.<sup>12</sup>

It is this last point that offers a clue to the difficulties involved here. Broadly speaking, returns to savings are taxed differently according to whether they accrue as interest, dividends or capital gains. The different taxation treatment of each depends significantly upon the legal characterisation of the instrument from which the return arises: whether it is debt or equity or some other asset. Modern financial innovation has ensured that what looks like a return to an equity instrument can in fact be made equivalent to the return to debt, and vice versa, and there has always been scope to convert income into capital. Neither economists nor accountants recognise the ways in which the tax system classifies and taxes returns to savings. Accordingly, the battle between the Revenue and tax professionals who exploit rules that tax returns in different legal forms at different effective tax rates is ongoing.

Since 2004, the Revenue’s armoury has been supplemented by rules requiring the early disclosure of the latest tax avoidance ideas, especially in relation to financial products. As a result, anti-avoidance legislation has had to be tweaked every year to deal with the latest tax planning ideas. The proposals in the consultative document accordingly have less to do with simplification than with providing the Revenue with an effective weapon in the form of generally expressed legislation that does not have to be amended every year and which it can supplement as necessary with non-statutory guidance.

It is possible that this approach, if adopted, may provide a more satisfactory solution if, for example, non-statutory guidance proves to be more comprehensible and administrative action

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<sup>11</sup> Source: [http://www.hm-treasury.gov.uk/media/2/A/consult\\_financialproductsavoidance061207.pdf](http://www.hm-treasury.gov.uk/media/2/A/consult_financialproductsavoidance061207.pdf).

<sup>12</sup> The current draft of the legislation does not express these principles as such and appears to be considerably defective. One assumes, however, that the consultation process should highlight these deficiencies of the draft and that, if enacted, the legislation would give satisfactory effect to the principles.

ensures greater certainty for taxpayers to know in advance how their transactions will be taxed. ‘Simplification’ here lies largely in achieving a greater degree of certainty for taxpayers in a complex field and whether it is better to achieve that certainty through continuing elaboration of complex legislation that may still have gaps through which transactions may pass untaxed, or with shorter and simpler legislation supplemented by Revenue guidance. The adoption of the latter approach goes against English legislative traditions and raises significant issues as to the degree of discretion that is allowed to the Revenue in these matters and the ability of taxpayers to contest the Revenue’s view on appeal.

The fundamental difficulty that general principles drafting has to address, however, is how can you satisfactorily express a general principle in the context of a taxing Act that lacks any clear underlying principle in categorising returns to savings in different ways, basically depending upon whether the return is to some extent certain or contingent? The lack of any clear economic principle to the existing system is why the Revenue has had to amend current legislation every year. The only difference that principles-based drafting may make is that in future the Revenue may be able to amend its guidance rather than ask Parliament to amend its legislation. As such, the new approach may in the end offer taxpayers no greater certainty than they have at present.

## **13.4 Conclusion**

The Tax Law Rewrite has demonstrated that there is more to simplification than just replacing concise technical legal language with more voluminous ‘plain English’. As an element of the tax system, there are undeniable benefits in ensuring that the legislation is written in a more accessible form, even though the overall benefits of doing so may be relatively limited and offset by the greater volume. The majority of complexity, however, surrounds the concepts upon which the legislation is built, the structure the system adopts in terms of tax rates and taxable units, and the extent to which the government chooses to use the tax system to achieve particular policy objectives.

Within this matrix, some taxes are conceptually difficult – for example, taxes on savings and taxes on profits – while others are conceptually simple but may have features that make them administratively difficult – as, for example, aspects of VAT, PAYE and NICs. The three illustrations given above – buildings allowances, capital gains and financial avoidance – fall into the first category of conceptually difficult taxes. In each case, simplification requires some compromise with what would be ideal because what is ideal is likely to be more complex rather than simpler. At the same time, the choice of tax rates and taxable units – for example, the family or the individual, a single company or a group – can have a profound effect on the relative complexity of any tax. A value added tax that distinguishes many different products and services and taxes them at different rates is likely to be more complex than one that adopts a single rate. A tax system that taxes individuals but pays tax credits to families is liable to be more complex than one where both elements of the system are based on the same unit of assessment. In this respect, the government’s income shifting proposals for small businesses are unlikely to simplify the taxation affairs of those businesses.

Experience suggests that ‘simplification’ is easily espoused but is rarely achieved with any lasting success. The lesson is that simplification is difficult to achieve without more

fundamental consideration of tax bases and tax structures and that ‘simplification’ measures are often just one piece of a complex jigsaw that comprises the tax system. Solving the issue of complexity requires that we recognise what is complex and why and concentrate on what can sensibly be done about it. In this respect, the government’s approach of identifying particular elements of the tax system for review is a start. At the end of the day, however, government must be clear as to what its policy goals are. We can then see whether its goals are complicated – possibly too complicated – or just its methods.