corporate financial management

TAX SYSTEM

The tax labyrinth

TREASURERS WILL EMPATHISE WITH THE ACCA'S RENEWED CAMPAIGN TO SIMPLIFY THE UK'S COMPLEX TAX SYSTEM, REPORTS **GRAHAM BUCK**

Executive summary

- The UK's complex tax system is ripe for change, but its technical nature makes it difficult to simplify. Small adjustments, such as the cap on UK subsidiaries' tax reductions for interest payments, rouse controversy, while developments like the new Corporation Tax Act only exacerbate a problem worsened by the recession.

A long-running campaign by HM Revenue & Customs has attempted to persuade us over the years that "tax doesn't have to be taxing". But the message has never been very convincing; indeed the government's pressing need to devise new forms of fundraising suggests that it will be more taxing than ever in the years ahead.

As Chas Roy-Chowdhury, head of taxation for the Association of Chartered Certified Accountants (ACCA) recently observed, the downturn makes it more vital than ever that both large and small businesses have a tax policy that is transparent, certain and simple to understand.

The current system is unnecessarily complex and costly, placing a burden on the UK economy, he suggests. But the strong link between tax policy and electoral success presents an obstacle to any real reform, and "a deeper understanding of tax policy" is needed if there is to be any real cultural or political change.

The ACCA recently launched a discussion paper entitled 'Is there a way out of the tax labyrinth?' which called for two groups to be set up to help the Tax Law Rewrite Project (TLRP). An HM Revenue & Customs (HMRC) project launched back in 1997, TLRP is an ongoing initiative to make the UK's tax legislation less complex and more consistent by replacing archaisms with modern language and terminology.

What stands in the way of these ambitions being achieved? A major obstacle is the fact that complicated tax legislation is technical by nature and so resistant to simplification. As people get accustomed to the technical terms employed, making any changes to them becomes more difficult.

The ACCA paper maintains support for plans first put forward by the Association in 2000, under which two new bodies, collectively known as the Tax Policy Committee, would be set up to work with the TLRP and share information on UK tax. The first would aim at simplifying tax legislation; the second would review prospective new tax legislation with a view to eliminating "reactive and rushed-through tax laws".

This proposal sounds very laudable. However Martyn Smith, director of tax and treasury for Dyson, is reserving judgement on the ACCA's proposals, which he says could prove effective but equally run the risk of merely setting up a "talking shop" that creates added cost without providing value.

He believes the biggest tax issue is the proposed introduction of a worldwide cap on tax reductions for interest payments claimed by the UK subsidiaries of multinational companies. After more than two years of discussions and several months' postponement, the cap takes effect from the start of this month.

"This could have the effect of making the UK a less attractive place to locate finance and treasury companies, as well as slowing up the tax system even further," Smith suggests. "There could also be additional unintended consequences – although to its credit HMRC at least recognised that the initial proposals had not been fully thought through and were willing to explore ways of making them work better."

The change follows the basic principle that companies should not be permitted to deduct interest costs from tax in the UK if they exceed the interest costs in their operations worldwide. However, the legislation needed to effect it also needs to comply with European treaty provisions on the free movement of capital.

Earlier this year, the treasury admitted that the new rules could potentially impose excessive compliance costs on business and promised to explore ways of mitigating the financial burden.

Some tax analysts warn that the cap risks making the UK less attractive to overseas investors and will undermine its role as a prime location for foreign direct investment.

Chris Sanger, head of tax policy at Ernst & Young and also deputy chairman of the Institute of Chartered Accountants in England & Wales (ICAEW), has warned that the change is more advantageous to "companies which are forced to borrow in the markets than those with deep pockets".

The proposal to reduce tax deduction to reflect a proportionate share of a multinational's worldwide expense might appear to have little effect on only a limited number of companies; namely those that have over-leveraged their UK businesses, adds Neil Edwards, leader of the treasury tax practice at PricewaterhouseCoopers. However, the need to make the new rules European Union-compliant has actually made them very burdensome.

"Gateway tests were proposed, under which the companies that complied would have escaped the full burden of compliance. However, the reality has been that it is very difficult, if not impossible, to actually devise an EU-compliant gateway test so most companies will now have to meet these far more complicated rules," he says.

COMPLEX AND TECHNICAL LEGISLATION What other tax headaches do treasurers have to contend with? One of the most recent is the new Corporation Tax Act, which took effect from 6 April. The aim is to present basic corporation tax legislation in a more accessible style, and while the legislation covers issues such as loan relationships, derivatives and foreign exchange (FX) there is further work still in the pipeline on areas such as tax rates, losses and special regimes for specific businesses.

The desire for greater tax simplicity is undermined by the fact that the legislation is both complicated and technical by nature, so resistant to change says PwC's Edwards. As more provisions are added, so this complexity increases. "It's hard for companies to find their way through the maze – not just because of the complexity but also the constant change that has marked the past few years," he says. "People want a steady base and some certainty that the tax law won't be different again in another 12 months' time."

But the government lacks a "coherent policy position" regarding what it really requires of the UK's tax system, which is generally perceived as "incredibly complicated" compared with those of most other countries.

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"Although policy papers indicate a desire to improve the competitiveness of our tax regime and reduce the compliance burden, translating words into actions has proved rather more difficult."

In some cases the changes have been driven by the European Union, where the government has had to amend legislation to make it EU-compliant. A recent example was the revision of the late interest rules, which was a part of last April's Budget.

The Chancellor also added five new provisions to address the taxation of foreign exchange, including the introduction of a targeted anti-avoidance rule (TAAR). While the aim of addressing abuses of the rules is laudable enough, says Edwards, the net effect is to make normal commercial transactions even more complicated.

VOLATILE MARKETS ADD PRESSURE What other tax issues should treasurers keep under review? Edwards says the impact of the credit crunch on inter-company loans has become an area of concern.

"Volatility in the markets and the lack of liquidity means that the pricing of inter-company interest rates has become very problematic," he observes.

"Treasurers need to ask whether such loans can be accomplished by any other means in the light of current market conditions."

Another topical issue is that of managing inter-company foreign exchange exposures. While most inter-company loans are made in dollars, FX rates have been extremely volatile in recent times and even relatively small balances have given rise to major FX gains and losses.

"Loans are often put into special vehicles so that there is no foreign exchange for tax purposes and the company is provided with tax neutrality," says Edwards. "This situation has existed for many years and the Revenue should, in theory, be happy with it. But it is now under review by accountants and threatens to be problematic as companies adopt IFRS accounting.

"The Revenue lobbied to introduce rules that would address the issue, but lack of space in the Finance Bill has been used as an excuse for not taking any action."

A very recent bone of contention, albeit affecting finance directors rather than treasurers, is the rule announced in the April Budget to prevent companies from persistently under-reporting tax. Similar to the Sarbanes-Oxley in the US, it would require an individual – the "senior accounting officer" or finance director – to certify that the company's tax accounting systems are adequate and produce accurate calculations. The resulting protest has already seen the Treasury agree that fewer than 2,000 of the UK's largest business will be affected by the change, instead of the 15,000 initially envisaged. However, affected companies have protested at being made immediately compliant with the new measure as well as the cost of compliance which they estimate at between £50,000 and £250,000.

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