

COMPLIANCE COST REVIEW

CORPORATION TAX : RELIEF FOR THE EXPENSE OF MANAGING INVESTMENTS

1. Introduction

1.1 Background

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in an Impact Assessment (IA) when the associated legislation is laid before Parliament. Interim “consultation stage” IAs may also be published as part of consultation prior to implementation.¹

This document summarises the outcome of a post-implementation review of the above Corporation Tax IA published on 3 March 2004. The measure was implemented with effect from 1 April 2004. A copy of the published IA is attached.

This review re-assesses the compliance cost analysis published in the original document and addresses two main questions:

- whether the estimates of compliance costs used in the IA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the IA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

2. The published Impact Assessment

2.1 Description of the policy change

This reform addressed concerns over the difference in tax treatment between investment companies (as defined in the Taxes Act 1988) and trading companies. In simple terms, investment companies qualified for tax relief on the expenses associated with managing their investments, while other companies did not.

¹ Impact Assessments were previously known as Regulatory Impact Assessments, but were renamed in 2007 for simplicity.

The reform amended sections 75 and 76 of the Taxes Act 1988, with the aim of modernising and simplifying the rules. The main changes to section 75 were:

- extending corporation tax relief for the expenses of managing investments, by lifting the requirement to be a qualified investment company;
- modernising the rules for the timing of relief; and
- removing the requirement to be a UK resident company in order to obtain relief.

Section 76 was also rewritten, both for consistency with the above, and to improve clarity. The effect was to modernise the rules whereby life insurance companies could obtain relief for the expenses of their basic life assurance and general annuity business.

2.2 Anticipated compliance costs or savings

Besides the expected increase in the amount of tax relief claimed (which is outside the scope of this compliance costs review), the IA identified two main benefits for business:

- the removal of any requirement to artificially structure companies to obtain tax relief would potentially reduce audit and compliance costs; and
- the better alignment of the timing of any relief with accounting requirements, would simplify administration;

The reform was not expected to change the underlying record-keeping requirements for businesses, and hence the IA predicted no change in recurring costs. There might be a one-off cost if a company decided to restructure (i.e. if their current structure had been driven by tax considerations rather than commercial interests) but such a cost would be offset by the administrative savings of running a simpler structure in the future.

Businesses consulted at the time anticipated “nil or minimal” costs and were supportive of the reform. They said at the time that the administrative modernisation was worth more to them than the increase in tax relief (around £20 million per annum) alone.

Although this does imply a figure of at least a £20 million reduction in compliance costs, the IA did not explicitly quantify the compliance costs and benefits.

3. Conduct of the review

Each compliance cost review (CCR) is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, the review was led by an HMRC project team supported by consultants. The staff in the review team were completely independent of those involved with the original policy change.

An essential element of the review was drawing on the consultants' expert knowledge of those affected, and their ability to engage with them through a mix of informal consultation and in-depth interview. The research was not intended to deliver any degree of statistical robustness (to do so would have been costly and impractical) but instead to provide indicative findings. This has allowed the research to identify the major issues and any associated learning points.

The external research was complemented by an internal review of HMRC paperwork and electronic files.

4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	Comments
Were the specific types of cost and benefit identified in the IA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?	The IA referred to administrative costs generally and possible group simplification. Generally, respondents agreed that the impact on administrative and training costs had been negligible, as anticipated. In most instances software providers had absorbed updating costs. None of those questioned was aware of restructuring benefits having arisen in their groups, although they appreciated that the reform might have allowed other groups to simplify their structures.
Were costs/savings incurred at the expected time?	The minor one-off costs of familiarisation were incurred at the expected time. Respondents have not identified any savings, although HMRC would expect to continue monitoring the situation because restructuring impacts (both costs and savings) might arise only in the longer term and/or in a minority of businesses.
Were costs/savings incurred by the expected people?	Yes – although the general picture is of a minimal impact on compliance costs. Research suggests that some groups may have taken a fairly pragmatic approach in applying the earlier legislation and that as a result the administrative simplification in many instances would have had no (or at most minimal) cost savings, simply because the existing system was operated fairly efficiently.

Were any other costs/savings, not identified in the IA, incurred ?	No. The research has not identified any omissions in the original analysis.
If the type of costs/savings varied from the original estimates, why was that?	The original assessment remains valid. The likelihood and impact of restructuring may have been overestimated, but the IA did describe these as potential impacts, rather than definite ones. The potential for restructuring does remain, but there is no evidence of it making an impact to date.
Could such variances have been foreseen at the time?	Not applicable.
What is the assessment now of the total value of costs and savings?	Respondents believed the total change in compliance costs to have been nil or negligible for their businesses. In part, this is a result of the reforms not being significant enough, when compared with commercial considerations, to affect group structuring decisions.
If different from the original IA, what has caused the discrepancies?	The original assessment remains valid.
With hindsight, were the compliance cost estimates accurate?	Based on the respondents' experience, the estimates appear to have been correct, except that the IA probably over-estimated the likelihood of group simplification benefits.

5. Was the process used to estimate compliance costs reasonable?

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

Question	Comments
Who worked on the original IA?	The original work was led by Corporation Tax policy experts, supported by colleagues. Other agencies, such as the Small Business Service in the then Dept. of Trade and Industry, provided advice.
Was an adequate audit trail maintained?	Yes.

Was Cabinet Office and/or internal HMRC guidance on IAs followed correctly?	Yes – the original IA covered all the issues it should have done.
How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?	This particular IA relied heavily on consultation to inform the analysis of compliance cost impacts. This provided a good evidence base for the assessment and there is no evidence that the amount of research at the time was inappropriate.
Were the right people (both internal and external) consulted, and were their views reflected appropriately?	Yes. The level of consultation was good, and the IA itself outlined the various exchanges that took place at the time.
Did those who were consulted when the IA was written express views on the reasonableness of the process?	The CCR review team is not aware of any specific comments being made about the process, but businesses were in favour of the reform and fully engaged in dialogue.
Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?	Respondents generally agreed that the RIA process was reasonable in this particular case, and have not identified any major concerns.
Were compliance costs estimated for all options mentioned in the IA?	The IA considered two options: the one that was implemented and leaving things unchanged. These were compared with each other, but the final IA did not propose or analyse any other option. Given the amount of consultation that occurred prior to the final IA, we consider that this simplification was reasonable. However, we recommend that in future, IAs should include a fuller discussion of options. This will help IAs demonstrate that the recommended option is superior, not just to the status quo, but also to possible logical alternatives.
Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?	The IA covered different groups (for example the insurance industry) and recent research has not identified any concerns with this approach. Our consultants considered that the compliance costs of smaller businesses would be less affected by the changes in practice, and that the IA's comments on smaller businesses at paragraphs 34 and 35 were consistent with that. In general, small businesses have not needed to alter their records or structures to apply or benefit from the legislative changes.

<p>Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?</p>	<p>Yes. The reliance on stakeholders to advise on the implications was reasonable and indeed desirable. It is not clear to the review team how much quality assurance was done of those third party estimates at the time, but the CCR has confirmed now that they were broadly accurate.</p>
<p>Was there sufficient time to produce a robust assessment of compliance costs?</p>	<p>Yes. The final IA followed an extended period of consultation and analysis.</p>
<p>Were any assumptions reasonable, given the circumstances at the time?</p>	<p>The compliance cost assumptions were heavily informed by businesses and felt to be reasonable. The more recent research confirms that. In particular, it was reasonable to assume that groups would make changes to their profit calculation systems to ensure they benefited from the reform. Those consulted now have given examples of changes to data collection procedures, particularly in respect of potential capital expenses.</p>
<p>Were any estimates of compliance costs caveated appropriately?</p>	<p>The IA was worded to emphasise that costs and benefits (such as those arising from restructuring) were potential rather than certain impacts. Respondents generally considered these caveats to be appropriate in the circumstances, and the fact that the subsequent impacts were small endorses the original drafting.</p>
<p>Were any risks correctly identified, addressed and explained?</p>	<p>Yes. Those affected have not identified any problems.</p>
<p>Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?</p>	<p>Not applicable. We are not aware of any issues of this nature.</p>
<p>Would HMRC do anything differently if the exercise were repeated, and hence could the IA process have been improved?</p>	<p>There is no evidence to suggest that a change in process is required. Respondents considered the consultation process as being crucial to the accuracy of the IA, especially with respect to the recasting of s76.</p>

6. Learning points arising from the review

6.1 Learning points for future work in this policy area

- One detailed recommendation to emerge during the research is that HMRC should consider the additional accounting costs if a change impacts deferred tax. This issue would be particularly significant where groups are applying more than one accounting principle for reporting purposes. Similarly, IAs should consider and identify any implications for accounting disclosure procedures.
- This is not a CCR learning point as such (being out of scope) but some respondents implied that further simplification might be possible in relation to Section 76, without impacting the tax base. Section 76 deals with the expenses of insurance companies, and while respondents were not precise in their comments regarding simplification, they appeared to suggest that this provision may be slightly too narrowly drawn. The CCR review team has passed this feedback to the relevant policy team in HMRC for possible consideration in future.

6.2 Learning points for the IA and compliance cost process in general

- This CCR reaffirms the benefits of continuing and timely consultation throughout the policy development process.
- All IAs should demonstrate that the preferred option is superior, not just to the status quo, but also when compared with other “logical alternative” options. In practice, this means that all IAs should explain whether other options had been considered, and why they had been rejected.
- Where an IA considers a reform may cause or encourage businesses to restructure, the likelihood of that occurring should be made explicit. The likely balance between commercial factors and tax-related factors, in driving such restructuring, should also be assessed if possible.
- Where compliance cost estimates are supplied by business, the IA should state what quality assurance (if any) has been completed by HMRC. This will ensure that third party evidence is both representative of business as a whole, and consistent with any separate HMRC analysis. (The use of third party evidence and consultation remains extremely valuable, and this recommendation is intended to maximise that value. There is no suggestion that the actual evidence used in this case was inappropriate.)

7. The way forward

Comments are invited on any aspect of this report or the wider compliance cost review programme.

The learning points are being fed into the policy development process directly if particular to one IA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to improve the IA process as a whole.

8. Contact points for further information

For issues relating to your own corporate tax affairs, please contact our Employer Helpline:

Telephone: 0845-714-3143 (Mon-Fri 8am-8pm, Sat-Sun 8am-5pm).

For issues relating to investment expenses policy specifically:

Simon Moulden

CT & VAT

HM Revenue & Customs

Room 3/35, 100 Parliament Street

London

SW1A 2BQ

Telephone: 020-7147-2629 E-mail: simon.moulden@hmrc.gsi.gov.uk

For issues relating to the compliance cost review programme generally:

Richard Bowyer

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LONDON

SW1A 2BQ

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E-mail: richard.bowyer@hmrc.gsi.gov.uk

ANNEX : THE PUBLISHED REGULATORY IMPACT ASSESSMENT

<http://www.hmrc.gov.uk/budget2004/managing-investments.pdf>