

COMPLIANCE COST REVIEW

CORPORATION TAX RELIEF & EMPLOYEE SHARE SCHEMES (2003)

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 a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published in March 2003 for the above-mentioned measure by the Inland Revenue (prior to creation of the new department, HMRC). The measure was implemented with effect from January 2003. A copy of the published final RIA is attached.

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

- whether the estimates of compliance costs used in the RIA 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 RIA 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 RIA

2.1 Description of the policy change

The Government wanted to encourage the use of employee share schemes in anticipation of improvements in business productivity. Prior to this policy change these schemes were commonplace in larger companies but there was no method in place to claim an automatic corporation tax deduction for the costs of these schemes. Despite

this, many of the larger companies managed to obtain corporation tax deductions by using arrangements involving trusts.

The cost and complexity of such arrangements acted as an effective bar to smaller companies, making them less likely to run an employee share scheme or to secure corporation tax deductions if they did decide to operate an employee share scheme. Even larger companies found these arrangements burdensome and the arrangements themselves did not always provide a high degree of tax certainty.

The policy change removed the need for complex arrangements designed solely to obtain a Corporation Tax deduction, thereby encouraging and enabling companies to create or expand employee share schemes. It was designed to level the playing field between the use of cash and equity as remunerations and provide greater clarity, fairness and reduced bureaucracy.

2.2 Anticipated compliance costs or savings

The RIA estimated that the current arrangements would cost a company between £5,000 and £25,000 to set up, plus between £2,000 and £10,000 per year to run. For the largest firms these costs could be as high as £100,000 initially, plus £30,000 per year.

Companies which operate such arrangements solely for the purpose of claiming a CT deduction would no longer need to incur these costs. The RIA estimated that over 5,000 businesses would benefit, although it did not provide an estimate for the total reduction in industry compliance costs.

The qualitative commentary included the following:

- The timing and amount of the corporation tax deduction would match the amount of employment income from share acquisition chargeable to tax on the employee. Employers maintain records of employee share acquisitions so the alignment of the CT deduction with the tax charge on the employee should not mean significant extra work for companies.
- Unquoted companies might be required to do additional valuation work in relation to their shares where there is no employment income tax charge, for example, because they are operating a tax advantaged share scheme, although this compliance cost would have been outweighed by the value of the corporation tax deduction previously foregone.
- Companies would have to track share options and share awards during the transitional period in order to avoid the possibility of making double deductions in respect of the same shares under the old and new regimes. However, existing records should suffice to meet this requirement.

Overall, the change was expected to be deregulatory with significant reductions in compliance costs for some firms.

3. Conduct of the review

Each compliance cost review 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 consultation with those actually affected, and consultants were commissioned to carry out a small number of targeted in-depth interviews with some of those affected. 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. Coupled with the consultants' own knowledge and expertise, 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 RIA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?	<p>HMRC identified most of the compliance cost impacts arising from the introduction of the legislation. However, respondents consistently commented that the required process for tracking share options was considerable and more extensive in nature than that set out in the RIA. This represents an additional ongoing cost.</p> <p>In terms of compliance savings, the main comment was that savings had not been achieved because trust arrangements continued to be used. There were wider commercial reasons (i.e. beyond CT deductions) for setting up the trust arrangements originally, and so the anticipated cost savings arising from cessation, as set out in the RIA, were less likely to be</p>

	<p>realised. Respondents did agree that where firms had ceased using a trust arrangement, savings would have been accrued. The issue was that many firms might not have done that (for commercial reasons).</p>
<p>Were costs/savings incurred at the expected time?</p>	<p>Subject to the above comments – yes. There was some feeling the changes were more difficult to implement than expected because of the need to consider (unrelated) changes in accounting requirements at the same time. This extra complexity may have delayed the timing to some extent.</p>
<p>Were costs/savings incurred by the expected people?</p>	<p>The RIA correctly identified the population affected. A few issues have emerged since, although the impact of each is likely to be minor:</p> <ul style="list-style-type: none"> • lossmaking firms were much less likely to be affected; • for some firms, the changes coincided with other system changes (like the accounting reforms mentioned above). Although achieving economies of scale, this made it difficult to separate this RIA from other reforms, and hence judge precisely who was affected and how; and • the costs for unquoted companies would be substantially greater than for quoted companies because of the need to undertake formal share valuations. <p>The RIAs estimate of 5,000 firms affected stands, although the assumptions about how they would react, and hence how much they would save, were optimistic.</p>
<p>Were any other costs/savings, not identified in the RIA, incurred ?</p>	<p>The RIA was broadly accurate, but feedback does suggest that new processes of gathering information needed to be devised, and that this additional burden could have been covered in more detail in the RIA.</p> <p>A number of respondents commented that they needed to call in external advisers in order to deal with a “knowledge gap” in their business in relation to the new legislation. This was not commented on in the RIA.</p>

	<p>Costs have been additionally incurred as a result of changes in accounting standards affecting share schemes. These have also had an impact on the administration required to obtain the new corporation tax deductions. This is touched on in the RIA but not discussed in detail and only in relation to the tax position.</p>
<p>If the type of costs/savings varied from the original estimates, why was that?</p>	<p>The two main reasons are:</p> <ul style="list-style-type: none"> • firms did not end their trust arrangements as predicted (because of other commercial reasons for having them); • HMRC's view that companies could use existing systems for tracking information was optimistic.
<p>Could such variances have been foreseen at the time?</p>	<p>Yes. Those affected believe that many of these issues could have been identified through additional consultation (even though there was some consultation at the time, and a partial RIA was published in 2002 seeking views).</p>
<p>What is the assessment now of the total value of costs and savings?</p>	<p>None of the respondents were able to give an actual financial estimate of either the full one-off implementation costs or ongoing compliance costs. However, they felt that the actual costs incurred were broadly in line with those anticipated in the RIA.</p> <p>Savings, as discussed, were not achieved where firms had maintained their pre-existing arrangements.</p>
<p>If different from the original RIA, what has caused the discrepancies?</p>	<p>Feedback from businesses suggests that the more commercial aspects relating to the implementation of share schemes were not considered in sufficient detail by HMRC during the RIA process. These issues meant that the potential cost savings identified in the RIA did not materialise for some firms.</p> <p>That said, the RIA did make clear that this was a possibility – although it did not attempt to estimate how many, or what types, of the 5,000 firms affected would choose to retain the established arrangements.</p>

<p>With hindsight, were the compliance cost estimates accurate?</p>	<p>This can best be summed up with two comments made by those affected:</p> <ul style="list-style-type: none"> • “The RIA was reasonably accurate in assessing the cost impact”; but • “HMRC failed to take into account all of the other additional burdens that exist in relation to the management of share schemes and how these impact compliance costs.” <p>The latter point meant that anticipated savings were not achieved for some firms.</p>
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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
<p>Who worked on the original RIA?</p>	<p>A team of policy experts, analysts and Better Regulation advisors were all involved.</p>
<p>Was an adequate audit trail maintained?</p>	<p>Yes, particularly on the policy side. The record of supporting analysis was limited (consistent with the fact that this RIA was primarily qualitative in nature).</p>
<p>Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?</p>	<p>Yes - the RIA followed the guidelines in place at the time.</p>
<p>How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?</p>	<p>Although, with hindsight, more research could have been beneficial, the amount of effort at the time was reasonable and proportionate given the importance of the measure.</p>
<p>Were the right people (both internal and external) consulted, and were their views reflected appropriately?</p>	<p>Internally - yes. Externally - HMRC interviewed 19 companies of varying sizes and trading activities. The results of these interviews fed into a Partial RIA that was published in December 2002, which sought wider comments on the draft proposals.</p> <p>The feedback now is that more consultation would have been beneficial, and it is possible that at the time, HMRC may have had trouble identifying willing consultees. Some of the</p>

	issues that have now emerged were clearly not raised at the time and we have drawn out a few learning points accordingly in section 6 below.
Did those who were consulted when the RIA was written express views on the reasonableness of the process?	No comments were made at the time.
Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?	<p>Yes – and they have made a number of suggestions for possible improvements in similar RIAs in future:</p> <ul style="list-style-type: none"> • Separate compliance assessments for small and large, international and national companies could be undertaken by consulting a range of businesses; • The unrelated but parallel accounting changes also required by business could have been covered in more detail and considered in terms of how this might have affected compliance costs (essentially this is about linking the proposed reform with other reforms and the wider context – not focusing solely on the one reform at hand); • Wider consultation might be achieved in order to obtain a balanced viewpoint, and in particular to gain additional insight into the commercial impact on business that the reform might achieve; and • A brief summary of the legislation might have been provided at the beginning of the RIA document.
Were compliance costs estimated for all options mentioned in the RIA?	No - only for the preferred option.
Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?	Not in detail, and this is something that respondents have picked up on. Recent feedback suggests that (e.g.) very few small businesses operate share schemes, and additional analysis of the varying impact on different types of firm would have been useful.
Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?	The amount of analysis, particularly quantitative analysis, was limited. The RIA provides some numbers, but no indication as to the origin of those data, and hence their reliability. Given the range in savings provided and the variable

	<p>nature of the factors that would result in creating a saving, such explanation would have helped those affected judge the likely impact on themselves.</p>
<p>Was there sufficient time to produce a robust assessment of compliance costs?</p>	<p>There were no problems with the amount of time available. HMRC published draft clauses, an Explanatory Note and Partial RIA on 19 December 2002 following an announcement of the measure at the 2002 Pre-Budget Report. The Final RIA was published in April 03 to coincide with the 2003 Budget.</p>
<p>Were any assumptions reasonable, given the circumstances at the time?</p>	<p>The main piece of feedback is that the RIA placed too much focus on businesses being driven by tax savings when deciding how to conduct their affairs. While this is obviously significant, it is not the only motivator. If wider issues are overlooked, assumptions about business behaviour and associated costs or savings will be inaccurate.</p> <p>The recent feedback has also raised the problem of costs and savings being affected by a wide range of factors – not all of which can realistically be covered in an RIA. The decision not to itemise a long list of exceptions or caveats may be reasonable, but the fact that such a decision has been made, should be stated clearly.</p>
<p>Were any estimates of compliance costs caveated appropriately?</p>	<p>In general, the answer to this is “yes”, but respondents made clear that more detail was required to help them judge the impact on any specific firm. In particular:</p> <ul style="list-style-type: none"> • more background concerning the types of business upon which the figures were based should have been provided; and • the compliance cost impacts had been over-simplified and were in fact more complex.
<p>Were any risks correctly identified, addressed and explained?</p>	<p>The risks section of the RIA commented on the benefits of making the change and what might happen if it was not made. It did not address any risks that might arise from introducing this change.</p> <p>In practice, some of the key risks (e.g. of firms</p>

	not achieving savings) are self-evident or strongly implied, but there was little overt explanation to explain those risks and/or address them.
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)?	No. Feedback on the partial RIA was muted.
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	The RIA made some over-optimistic assumptions that businesses believe could have been corrected during consultation at the time. But responses to consultation at the time did not identify these issues as a cause for concern. This mismatch should form the primary focus for future improvement, and is the basis for several of the learning points identified below.

6. Learning points arising from the review

6.1 Learning points for future work in this policy area

- The more commercial aspects relating to the implementation of share schemes were not considered in sufficient detail by HMRC during the RIA process and addressing this in future should be a priority.
- Impacts in this policy area may vary according to whether a business is in profit or making a loss, and also according to whether they are quoted or not on the stockmarket.
- Further research with external share scheme specialists would also be beneficial. This would ensure that the detailed commercial aspects of share reward and the administrative impact across business are considered in future RIAs. The benefits would include (1) improved understanding of the possible and likely business responses to reform, and (2) more accurate assessment of the business activities required to introduce and manage such reform. In this case, businesses were consulted regularly, but the early focus was on how the legislation would be structured and it may have been difficult for businesses to identify detailed implementation issues until late in the day, or even post-implementation.
- Risks should be considered fully for any proposed reform, including the preferred option. In this case, the possibility that businesses might not change their existing trust arrangements was implied, but not considered in detail.

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

- A few issues were not identified during earlier consultation. The CCR review team does not have enough information to determine why, and indeed it is not possible to foresee everything. All of these learning points should be considered when designing consultation in future, to minimise the chance of particular issues being overlooked. Monitoring and evaluation plans could usefully be beefed up in RIAs, to give early warning of any deviation from the expected impact.
- All RIAs should consider the cost to businesses of obtaining, analysing and tracking data. Assumptions that existing systems will suffice should be justified.
- Assumptions that businesses will act in a certain way should be fully justified. In particular, business behaviour may not be driven by tax considerations alone and any assumptions that it is should be supported with evidence.
- Although each RIA will, in general, focus on one area of policy reform, the wider context and any interaction with other reforms or rules, should be considered if practical to do so. The particular examples in this case concerned interaction with accounting regulations and/or case law.
- RIAs should always consider the possibility of businesses needing to call in consultants or other advisers to assist with implementation.
- In an ideal world, RIAs will be published alongside or in advance of reform – not shortly after implementation.
- The RIA itself was felt to be reasonably clear, although a brief summary of the legislation might have been provided at the beginning.
- Where the range of possible costs or savings is wide, or data uncertain, appropriate explanation and caveats should always be included. In particular, the factors affecting the level of costs and benefits should be spelt out, so that readers can assess the implications in their own individual case. Any decision not to itemise a long list of exceptions or caveats may be reasonable, but the fact that such a decision has been made, should be stated clearly.
- RIAs should consider the risks attached to all options, including the preferred option. It is not sufficient to justify a reform solely by arguing that alternatives are disadvantageous.
- If an RIA asserts that businesses will change their modus operandi, the reasons behind that modus operandi – both tax-related and non-tax-related - should be explicitly covered in any consultation.

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 RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

8. Contact points for further information

For issues relating to CT relief and employee share schemes policy specifically:

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For issues relating to the compliance cost review programme generally:

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

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

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