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The party's over

How will the new coalition Government cope with the ongoing economic challenges, asks [Tim Keeley](#)?

At last, after six weeks of campaigning, punctuated by the temporary paralysis of UK airspace by volcanic activity in Iceland, and following three TV debates in which the main party leaders set out their stalls, and a subsequent embarrassing gaffe following a meeting between the former Prime Minister and an (ex) Labour Party supporter from Rochdale, the General Election of 6 May 2010 is over. For the first time in 36 years, the British public has declared no clear mandate for any party to govern alone.

We now know that the new Government is a coalition between the Liberal Democrats and the Conservative party, with David Cameron as Prime Minister and Nick Clegg as Deputy Prime Minister, but we have little idea of how our new political masters will tackle the worst financial crisis for at least a generation. It may be relatively easy to enter office full of fresh resolve, but it is much more difficult to deliver.

Whilst the UK's political parties were wooing the public for their votes, the economy of Greece was awarded 'junk' status and public demonstrations on the streets of Athens emerged, and the economies of some other EU countries are in an parlous state. Concerns that the UK could be heading in a similar direction have already been voiced.

Such a catastrophe has not yet reached our shores, but there is no doubt that action is required to control UK public finances if damage to the UK economy is to be limited. The spectre of a hung parliament, which in the minds of some commentators is a recipe for indecision has added to the urgent need to declare the detail of a clear and specific programme to tackle public sector debt. All the main parties realise this, and also that some of the measures required to achieve this will involve higher taxation and reduced public spending. So does the British public. With the election now over the new

Government must lose no time in declaring its hand.

An emergency Budget has been announced for 22 June and it would seem that the new Coalitions will waste no time in trying to get to grips with the public sector deficit. Steps to reduce this by a further £6 billion will shortly be announced – brace yourselves for a VAT hike to possibly 20 percent, potential rises in the Capital Gains Tax rate and reductions in family tax credits for middle income earners.

Yet in a volatile economic climate, it is likely that our new political masters have little more idea than our readership of how the UK economy will be performing in five years' time, or whether its economic policies will endure, or indeed if they will still be in office. Despite the recent announcements that the coalition is set to run a full five year term and with a fixed parliament. If the Government's financial strategy should undergo a complete volte-face during the lifetime of the next

Parliament, we should not be surprised. Some readers may remember the stalwart defence of the Sterling exchange rate at \$2.80 to £1, by Harold Wilson's Government of the 1960s, a policy which had to be abandoned because of the inherent over-valuation of Sterling and continuing overseas commitments which Britain could no longer afford. More recently, a former Chancellor and Prime Minister foretold the abolition of boom and bust. He was not the first, nor will he be the last politician forced to eat his words. Economic downturns may sometimes, like the forces of nature, appear to be unpredictable, but often they arise as a consequence of poor financial regulation. The fact that this was also a contributory factor in the Great Depression of 1929 may cause some to believe that all we have learned from history so far is our failure to learn from history.

So whatever financial strategy is outlined in the first budget of the new Government, it is unlikely to remain totally unchanged



in the next few years. The UK may still a sizeable economy in its own right (and arguably in better condition than some of its European neighbours), but it is still be a minnow when compared to China or the United States. Its ability to influence, still less control, economic events on a global scale is limited. Whilst that is not an excuse for condoning recklessness, equally the direction in which the UK economy moves during the term of this Parliament is something over which any government has limited control. No government can expect to deliver economic success on its own. Equally, and as has been demonstrated by the recent example of Greece, financial responsibility requires self-discipline and demonstrates the need for government to act responsibly, even in a global economic climate. Combining that need for self-discipline without driving the UK into a double-dip recession will require careful judgement.

So what are the priorities that the AIA would like to see the new government address? We set out our thoughts below, in what we hope is a balanced and non-partisan manner.

Restoring international competitiveness

The UK economy – like our membership operates in a global environment. For centuries, its fortunes have depended upon its ability to compete with global markets. Pulling down that competitiveness with excessive regulation and high taxes will blunt our cutting edge. Already the UK is slipping down the tables of some

who measure countries by economic competitiveness. Further slippage will lead to a loss of talent and to business relocating overseas (as is already happening).

Accordingly we would like to see policies introduced that will make the UK once again become a great location in which to live and work. These include, for example:

Limiting the burden on business

Unless the private sector is allowed to become more cost competitive, it will be more difficult for it to generate the economic activity that the Government will require to raise the taxes necessary to improve our public service and welfare commitments. Specifically, the cost to business of local rates, and of national insurance are two priorities that deserve urgent attention.

Slimming down the public sector

Those in business or in self-employment know only too well the consequences of inefficiency, the cost of which has placed some in insolvency and required those businesses which have survived to make economies. The public sector must not be immune and failure to tackle this will simply lead to increased tax costs, demotivating those individuals and businesses whom this Government should be seeking to encourage. We recognise that the timing of public sector reductions must be balanced against the danger of driving the UK back into recession, however, it is irrational to expect any economy to survive in the

long term on the premise that for every £5 that is spent by Government, £1 has to be borrowed. Steps to reduce the public sector deficit are required and they need to be more specifically defined now that the election is over.

Making the UK tax system more attractive

Action is required to reverse the perceived belief that the UK is slipping down the list of those economies where it is great to live and work. Tax policy is one area in which the Government can take a decisive role. In the area of business taxation, useful steps have already been taken. In personal tax however recent developments have been negative and at times have appeared almost purpose-built to drive talent away. Accordingly, a clearer definition of UK tax residence is required. Many jurisdictions now have a statutory residence test and the opportunity to introduce a similar test for the UK has so far been ducked. The recent developments in UK Case Law, notably in the recent Court of Appeal decision in *Gaines-Cooper*, and the guidance published by HMRC 6 leave elements of uncertainty in the interpretation of tax residence. With days of arrival now included in the number of days present for UK personal tax residence purposes and a presence of 91 days (or sometimes even less than this) being sufficient to trigger tax residence, the UK lags behind those countries with a clear statutory residence test, usually defined (as in the case of the Irish Republic) with a minimum period of stay on average closer

to 140 days than 91. Action is urgently needed to redress this imbalance. Taken together with the recent attack on the taxation of non-UK domiciled persons, the UK has become a less attractive place in which to live and work and urgent attention is needed to consider means in which the UK tax system might be used to encourage individuals of high talent to relocate here rather than drive them away.

The UK Corporation Tax system must be made more internationally attractive. There have been encouraging signs in this direction. We were promised in the 2009 pre-budget report that a new Corporation Tax regime for intellectual property would be introduced with a 10 percent tax rate. This concept is very welcome and its scope may usefully be extended.

Some European countries (for example Ireland) have preferential low rates of Corporation Tax for certain activities – in the case of Ireland a 12.5 percent Corporation Tax rate applies to trading profits. The UK could usefully consider if a similar incentive would attract businesses to relocate to the UK.

Domestic taxation

Simplification is urgently required. AIA would welcome a commitment by the new Government towards a simpler and more understood system of rates and allowances, and less upon political short term 'tinkering'.

The example of the zero percent Corporation Tax rate, introduced in 2002 only to be taken away in 2005, is one such example. In personal tax, we have seen the introduction of Capital Gains Tax taper relief in 1997, but abolished in 2008; and the 10 percent personal Income Tax rate, introduced in 1999, and abolished in 2008.

We would also like to see the new Government holding to the principle that depreciation, or capital allowance rates, should remain simple and be more geared to commercial reality. We have regretted the changes to capital allowance rules for plant and machinery introduced in 2008, which have restricted the rates of allowance (severely in the case of fixtures integral to a building), whilst at the same time 100 percent relief was introduced on the first £50,000 of expenditure (with an increase to £100,000 announced in the last Budget). We had moved successfully from an artificial situation of 100 percent first year allowances on plant and machinery introduced in the early 1970s, and having apparently moved into an era in which

capital allowances were based upon reasonable commercial practice, we have now drifted back into a situation where commercial costs genuinely incurred by business are being restricted with accelerated rates of relief being introduced at the same time for limited amounts of expenditure.

AIA would like to see business and personal tax rates structured to reward and not to penalise effort. The highest effective marginal rate of Income Tax, which is 60 percent if the withdrawal of personal allowances is taken into account, is incurred by individuals who are not top earners. Accordingly we would call upon the Government to remove this anomaly and also to commit to raising the income threshold at which the 50 percent tax rate applies as soon as possible. The need for additional taxes in the short to medium term to help finance current public spending requirements is accepted by many including ourselves, but sustained high levels of taxation serve only as a disincentive to enterprise and emphasise the need to address not only the need to raise revenue, but to reduce the burden that the public sector is inflicting upon taxpayers.

Consultation with HMRC

The opportunity to consult on proposed changes in tax law and practice has been a welcome development in which the AIA has been pleased to participate. We would wish this process to continue and be extended under the aegis of the new Government especially as it is the 'customers' of HMRC who are now financing most of the high level of public expenditure. They too are entitled to some of the 'fairness' that figured in the Liberal Democrats' manifesto published at the start of the election campaign.

Pension provision

The financing of future pension costs should be a priority of the new Government. The UK got off to a good start by recognising, long before its European counterparts, that pension funding was a ticking timebomb that had to be addressed. Unfortunately the abolition of dividend tax credits for pension funds, introduced not long after the previous Government took office in 1997, did much to devalue the net worth of private pension funds and should be reversed as a simple first step.

Secondly, the excellent simplification

introduced by the last Government (following A Day) should be taken a step forward by combining the basic state pension with the second state pension into a single state pension set at a realistic level (for example £8,500). At the same time, the statutory minimum contributions should be increased to finance this; and a sensible strategy for phasing in any increase in contributions should be worked out in combination with a gradual and carefully measured increase in the expected retirement age before state benefits can be taken to, say, 70 by 2040.

Partnership with business

The impact of recession and the opportunity to generate economic activity by spending upon public works projects provides a good opportunity for government and business to work in partnership. Accordingly we would welcome any priority that can be given to new construction projects consistent with being able to maintain a fair level of unemployment and social security benefits.

At the same time, the interaction of government and business provides a further opportunity to pursue expenditure projects that have a positive 'green' result. It is unfortunate that the recent economic debate between the main political parties during the election campaign has led to relatively little coverage of this important area, yet it remains an opportunity in which new technologies and government encouragement (possibly for example by way of a lower rate of Corporation Tax for profits generated from 'green trading activities') can work together.

Never again!

The new Government must prevent a recurrence of the circumstances which generated the recession from which we are all struggling to recover. This requires an overhaul of the existing financial service regulations and restrictions to prevent lending upon the scale that contributed to the banking crisis.

Like Jonathan Swift, we expect that other professional organisations will be setting out their own *Modest Proposals*. The AIA wishes the new Government well in the challenges that lie ahead.

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