The Capital Taxes Group of The Institute for Fiscal Studies

Research Report

Setting savings free: Proposals for the taxation of savings and profits

IFS Report, No. R44

Provided in Cooperation with:
The Institute for Fiscal Studies (IFS), London

Suggested Citation: The Capital Taxes Group of The Institute for Fiscal Studies (1994) : Setting savings free: Proposals for the taxation of savings and profits, IFS Report, No. R44, ISBN 978-1-87335-738-5, Institute for Fiscal Studies (IFS), London, https://doi.org/10.1920/re.ifs.1994.0044

This Version is available at:
https://hdl.handle.net/10419/64596

SETTING SAVINGS FREE

PROPOSALS FOR THE TAXATION OF SAVINGS AND PROFITS

The Capital Taxes Group of
The Institute for Fiscal Studies

Chaired by Malcolm Gammie

The Institute for Fiscal Studies
7 Ridgmount Street
London WC1E 7AE

Published by
The Institute for Fiscal Studies
7 Ridgmount Street
London WC1E 7AE
(Tel. 071-636 3784)
(Fax 071-323 4780)

ISBN 1-873357-38-8

Typeset by
Photoscript, Quinque House, Deddington, Oxon OX15 0SR
Printed by
KKS Printing, Stanway Street, London N1 6RZ

"Some men see things as they are and say
'Why?'
I dream things that never were and say
'Why not?'"

Robert Kennedy

(after George Bernard Shaw,
Back to Methuselah, 1921,
Pt 1, Act 1)

THE CAPITAL TAXES GROUP

SPONSORING FIRMS

Allen & Overy	Coopers & Lybrand	Linklaters & Paines
Arthur Andersen	Dickinson Dees	Macfarlanes
Binder Hamlyn	Ernst & Young	Mills & Reeves
Boodle Hatfield	Frere Cholmeley	Simmons & Simmons
Burges Salmon	Freshfields	Slaughter and May
J F Chown & Co.	Herbert Smith	Speechly Bircham
Clifford Chance	KPMG Peat Marwick	Touche Ross

WORKING PARTY

Malcolm Gammie
(Chairman)
Linklaters & Paines, IFS and The Institute of Taxation

John Avery Jones
Speechly Bircham
Mike Devereux
IFS and Keele University
Andrew Dilnot [1]
IFS
Dick Esam
formerly Shell International
Ken Etherington [2]
BAT Industries plc
Harold Freeman [3]
IFS
(Secretary to 3rd & 4th Reports)
Michael Keen [4]
IFS and Essex University

Michael Kell
IFS
(Secretary to 2nd & 3rd Reports)
Jonathan Leape
London School of Economics
Bill Robinson [5]
IFS
Edward Troup
Simmons & Simmons
David Wainman
Waltons & Morse
Charles Wookey
IFS
(Secretary to 1st & 2nd Reports)

---

[1] Andrew Dilnot joined the working party for the 3rd, 4th and Final Reports.
[2] Ken Etherington joined the working party for the 4th and Final Reports.
[3] Michael Keen left the working party as a result of other commitments during the course of the work on the 3rd Report.
[4] Harold Freeman rejoined the working party as a member in July 1992.
[5] Bill Robinson left the working party in January 1991.

CONTENTS

PREFACE

The Capital Taxes Group was established by The Institute for Fiscal Studies in September 1987 to enquire into the taxation of capital in the United Kingdom. The work of the Capital Taxes Group has been conducted by a working party and has been funded by a number of professional firms. The Sponsoring Firms and the members of the Working Party are listed at the beginning of this Report.

The Working Party would also record its appreciation to the many individuals who have over the years commented upon the various drafts of their Reports. Our thanks are due in particular to Michael Cayley.

The aim of the Group was to bring together tax practitioners and economists who, from their different perspectives of the same subject, could make sensible and practical proposals for tax reform. Since 1987, the Group has published four interim reports:

Reforming Capital Gains Tax, IFS Commentary No.8, February 1988
Death: The Unfinished Business, IFS Commentary No.10, November 1988
Neutrality in the Taxation of Savings: An Extended Role for PEPs, IFS Commentary No.17, December 1989
Equity for Companies: A Corporation Tax for the 1990s, IFS Commentary No.26, April 1991

This book sets out the conclusions reached in the Group's final Report – *Taxing Savings and Profits* – and the reasons for them. An order form for the final Report appears at the end of the book.

CHAPTER 1
SUMMARY OF PROPOSALS

Introduction

We summarise our proposals below and set out the reasons for them in the Conclusion on p. 59. The reader may therefore find it helpful to start with the Conclusion before looking at the detail of earlier chapters.

We have developed our proposals in the context of the current UK tax system, but our final Report contains more general lessons for the taxation of savings and profits. The system that we describe is particularly appropriate for adoption within the European Union. We have used the current UK system to illustrate how, in practical terms, our objectives for savings and profits can be achieved. We show how our proposals produce over time a rational basis for taxing savings and profits.

Our proposals for savings taxation are based on the principle that income and gains earned on savings from taxed sources should be exempt from further taxation. They are designed to give individuals greater control over their savings. If adopted, savings decisions would be less influenced by the way in which savings are taxed. Individuals would be encouraged to save where it is most productive to do so and in forms best suited to their needs and circumstances.

Under our proposals for taxing business profits, companies would be encouraged to invest wherever they believe it to be most profitable to do so. They could finance their investments in the most appropriate form. Investment and financing decisions could be taken with less regard to taxation considerations. Businesses carried on by the self-employed would be taxed on a similar basis, ensuring a high degree of uniformity in tax treatment between companies and unincorporated businesses.

Our proposals for companies and business profits complement those for savings but do not depend upon them. If implemented in the UK, the proposals would over time improve the fairness of the tax system and make possible a significant simplification.

There are two main elements to the proposals:

- a savings plan under which no tax relief is given for savings but income and gains arising within the plan are exempt from tax;
- a deduction in calculating corporate and business profits for the funds that the shareholders or business proprietors have invested in the business.

In the UK these proposals translate into a considerable simplification of the current tax system, including the option to eliminate capital gains tax indexation. The changes needed to implement the proposals are set out below.

Personal Savings

- A new savings product known as the Extended Personal Equity Plan, or the "EXPEP account", would replace existing Personal Equity Plans ("PEPs") and Tax Exempt Special Savings Accounts ("TESSAs").
- Existing PEPs and TESSAs would be converted into EXPEP accounts.
- Savings in an EXPEP account could be invested in all forms of financial assets – for example, shares, government securities, corporate bonds, warrants, futures, options.
- EXPEP savings in particular would include ordinary cash deposits, such as bank and building society deposit accounts.
- The tax treatment of EXPEP savings would correspond to that currently extended to PEPs and TESSAs, namely:
  1. no tax relief would be given for amounts deposited in EXPEP accounts;
  2. income and capital gains earned on savings within EXPEP accounts would be exempt from tax;
  3. withdrawals from EXPEP accounts could be made at any time; and
  4. there would be no tax charge on withdrawals, whenever made.

- There would be a fixed limit for annual contributions to EXPEP accounts.
- The scheme would also allow *any* amount to be saved in an EXPEP account, provided those savings come from taxed sources. To achieve this, tax at the basic rate would be deducted from any amount saved in excess of the annual contribution limit. The tax deducted would be credited against the individual's other tax liabilities.

Corporate Profits

- Companies would be entitled to deduct a new allowance in calculating their taxable profits. The allowance would be based on the amount invested in the company by its shareholders.
- The allowance would be calculated at an official rate based on the interest rate on medium-term government securities. We call this system the *ACE corporation tax* (because it gives an Allowance for Corporate Equity) and we call the allowance the "ACE allowance".
- The shareholders' funds would principally comprise the capital subscribed by shareholders plus retained post-tax profits, after deducting dividends paid and any amount invested in another company. Existing companies would be entitled to calculate their initial shareholders' funds by reference to current share capital, reserves and asset costs.
- At present under the UK corporation tax, a tax credit is given to shareholders on distributed profits. The tax credit is repaid to exempt shareholders such as pension funds and PEP holders. The tax credit would be abolished – the ACE allowance gives an automatic tax credit to the company (instead of to its shareholders) on all profits irrespective of distribution (although distribution reduces the company's shareholders' funds for calculating its future ACE allowance).
- The system of paying advance corporation tax on dividends would be abolished.
- Tax at the basic rate would be withheld from dividends paid to individuals within the UK and to all dividends paid abroad, subject to tax treaty and European Union obligations.

- Dividends and capital gains on shares held by one company in another would be exempt from tax.
- The allowable costs of corporate assets would no longer be indexed for capital gains purposes, indexation being rendered unnecessary by the ACE allowance.

Transitional and Other Measures

Over time the larger part of existing savings would be transferred into EXPEP accounts. Income and gains on non-EXPEP savings – mainly large accumulations of existing wealth and savings from untaxed sources such as gifts and inheritance – remain taxable. The ACE corporation tax could be implemented with various transitional measures designed to mitigate its immediate impact on tax revenues, existing companies and the owners of their capital.

These reforms would provide the opportunity, if we wish, to make a number of other changes, consistent with the objectives of the EXPEP and ACE scheme and designed to rationalise and simplify the tax system. We mention a number of these changes in the following chapters.

CHAPTER 2
REFORMING THE TAX SYSTEM

"Evolution by Design"

Old Taxes and Tax Reform

"An old tax is a good tax." This adage reminds us that individuals and companies take decisions based on the tax system as it exists today. Change, even if presented as reform and however well intentioned, may unfairly penalise some and unduly benefit others. Tax reform should not be undertaken lightly.

But if we took this aphorism too seriously, nothing would ever change. Tax reform need not mean revolution. Indeed, it is "revolution" – sudden, unexpected and radical change – that creates unfairness for taxpayers who may not have considered how such a change would affect them when they planned their affairs. Setting goals and moving towards them in a consistent manner is a fairer and more satisfactory way to implement tax reform.

The Evolutionary Tax System

In fact, a tax system is rarely static. A tax system *evolves* over time as it reacts to changing political, economic, social, commercial and technological circumstances. Its refinement and development are essential and ongoing.

In the UK since 1979, Parliament has enacted over 3500 pages of tax legislation. This adds up to a great deal of change. Many measures have brought about sensible reform of the tax system and of its administration. Some have responded – not always in a rational and satisfactory way – to a variety of economic, social, commercial and other influences. Others have been tinkering, piecemeal and sometimes contradictory measures of uncertain benefit, based on dubious claims as to what they would achieve.

We need an overall perspective of the tax system. With this end in mind, we have pursued a process of "evolution by design" in our final Report. We set down our objectives for direct taxation and point out the direction that we must take to achieve them. That direction is framed in terms of the UK tax

system. However, our final Report deals in more general terms with the issues involved in taxing savings and profits.

Criteria for Good Tax Design

The Purpose and Effects of Taxation

The principal purpose of taxation is to raise money for government. Inevitably, taxation affects decisions. Sometimes taxation measures set out to modify behaviour. All too often, however, they affect decisions in unintended, unexpected and undesirable ways. Frequently they can be aimed only in a general way and, overall, distort rather than benefit decision-making.

Three Design Criteria

For this reason, we need to adopt sound principles to design satisfactory measures for taxing savings and investment. We use three main criteria:

- economic efficiency or "neutrality",
- fairness, and
- "transparency".

What do we mean by these?

Neutrality

Our savings decisions ought to be based on the return that we expect our savings to earn, on our willingness to take risks and on a view of when we will need access to the savings. People do not always take rational or wise decisions. We should nevertheless expect that, left to their own devices, most individuals will see that their savings are put to the most productive uses and those best suited to their personal needs and circumstances.

This is what we mean by an economically efficient or "neutral" system of savings taxation: one in which individuals can make their savings decisions – and change their minds – without regard to the way in which they will be taxed.

The same criterion of economic efficiency applies in taxing profits; ideally, we would like individuals to conduct their business in whatever form

– company, partnership or sole trader – best suits their circumstances. They should be free, without tax penalty, to alter their business form to meet changed circumstances. Individuals, through the medium of the business, should invest in those assets and activities that they expect to be the most productive. They should finance their investments in the most efficient manner. These are the elements of economic efficiency or neutrality.

Fairness

There are two aspects of fairness. First, individuals with *similar* abilities to pay tax should bear similar tax burdens. The tax burden should not differ in arbitrary and capricious ways between them. Second, those with a *greater* ability to pay tax should bear a larger share of the burden.

How best to assess an individual's ability to pay tax is a judgemental matter. However, it is important to assess the fairness of the tax system based on the system *as a whole*, and not just by reference to one element of it. Particular measures, or changes, may be regressive but, overall, the tax system may be both progressive and fair.

We associate fairness mainly with personal rather than business taxation. However, we would like businesses that make similar profits to bear similar tax burdens. The tax system should not confer a competitive advantage on one business over another.

"Transparency"

A transparent system is simple to understand and to administer and is practical. Individuals, personally and through their businesses, can understand what their obligations are and what they must do to meet them: i.e. what taxes they must pay, how much and when. A transparent system does not place undue burdens upon taxpayers; the tax consequences of their decisions are clear.

Evaluating Reforms

We do not pretend that designing a tax system that is neutral, fair and transparent is easy. And if *designing* an ideal tax system is difficult, *reforming* the existing one is even more so.

Nevertheless, we can ask two questions of any proposals for reform:

- Taking a balanced view of our three principal criteria of good tax design, do the proposals improve the existing system?
- Are the proposals practically achievable – i.e. can we move from where we are to where we want to be?

Our Proposals for Reform

We believe that we can answer these questions positively. Our final Report presents a coherent and achievable strategy for the taxation of savings and profits. The following chapters explain that strategy and our reasons for it. One principle underlies that strategy, namely this: income and gains earned on savings that we accumulate from taxed sources should be exempt from income and capital gains tax in our hands.

Savings and profits lie at the heart of the direct tax system and of most of its complexity. Our direction, if pursued consistently over time, should simplify and improve the operation and effectiveness of that system and make it more fair.

CHAPTER 3
TAXING SAVINGS

The Impact of Taxation on Savings

A brief review of the personal finance pages of any national newspaper illustrates that the way in which savings products are taxed, and *exemption* from taxation in particular, is an essential aspect of marketing those products. The growth and decline of different forms of savings in recent years demonstrate how tax measures direct personal savings down particular paths.

Is this desirable? This depends upon the answers to three further questions:

- What is the particular measure designed to *achieve*?
- Is taxation an *effective* way of achieving that objective?
- What, if any, are the "side-effects" of the particular measure?

Taxation measures designed to encourage particular savings may direct the flow of savings. It is often difficult to say whether such measures encourage new savings or merely reallocate existing savings away from their original application. There may also be little agreement on whether the particular objectives of the measures are desirable or whether the measures are appropriate ways of achieving those objectives. Views change over time. The side-effects may be unknown.

What often happens is that a particular measure has a clear aim but gives rise to an outcrop of unintended fiscal consequences. These appear, like molehills on a cricket pitch, as the accidental byproducts of unenlightened effort. The proliferation of different savings regimes may make it impossible to judge what each achieves when placed next to all the other measures.

Would it not be better if we were left to take our own decisions, unfettered by the way in which we will be taxed? We may all agree that everyone should save for retirement, or that a greater supply of venture capital is desirable. However, the tax incentives that encourage those ends have a profound effect on the tax system and on patterns of life-time savings. Other ways of achieving such objectives may be equally effective, better targeted and less distortive. We illustrate the variety of tax treatments that

attach to different savings products in the UK in the tables on pp.16–19. The different legal forms that savings products take produce an inevitable diversity of detailed tax measures. This would not matter if the net effect for the saver were the same. But the net effect is not the same, as a brief perusal of the tables reveals.

Apart from directing individuals down particular avenues, taxation and tax incentives also create "lock-in" effects. Individuals may decide not to sell shares because they will then have to pay capital gains tax. They may be reluctant to spend tax-favoured savings unless they can replace those savings at a future date in an equally favoured form. As a result, savings are not easily redeployed to new investments, even though that would be sensible; savings and consumption decisions are distorted.

Institutional Savings

Recent years have seen the growth of long-term institutional savings. Savings taxation is and has been a major contributor to this trend. Institutional savings do, however, offer economies of scale, in both the accumulation and analysis of information on investment performance and financial transactions. They also provide greater diversity of investment and a broader spread of risk than is possible within most individual portfolios. Even if savings were wholly exempt from tax, institutions would continue to play a central role in the savings market.

Nevertheless, by favouring particular savings products and long-term savings, the tax system allows financial products to be sold as much through their supposed tax benefits as by reference to their anticipated investment performance. Savings contracts become more complicated as a result, and more difficult for us to understand.

The performance of savings institutions can be difficult to monitor in any circumstances. But the mobility of savings may be inhibited once they are committed to particular products offering special tax incentives. Lack of mobility detracts from the most effective investment performance and prevents us from responding to poor results.

Directions for Reform?

Taxing All Savings Equally

One direction for reform is to tax all forms of saving in the same way. Tax would no longer feature in savings decisions because, whatever the decision, the same tax consequences would follow.

The international dimension of savings taxation makes it difficult to eliminate tax factors altogether. Access to international capital markets makes it increasingly easy – especially for the financially sophisticated – to save abroad. This is particularly so within the European Union. We must be concerned, therefore, not only with the way in which the UK taxes savings, but also with the way in which other governments tax (or exempt) savings. If the UK taxes savings more severely than other countries, it may encourage savings to flow abroad and discourage foreign investment in the UK or, at least, raise the price that UK business must pay to attract foreign capital.

We are unlikely to secure international unanimity on savings taxation, however persuasively we argue for it. Nevertheless, there are still attractions in seeking to deal with savings in a uniform manner in the UK. But *taxing* all savings in the same way raises a variety of problems. This becomes apparent when we consider the type of changes that we would need to make in the UK:

- no relief would be given for pension contributions, exemption for pension fund and personal pension plan investment would cease and individuals would be taxed on the accruing value to them of any defined benefit pension scheme; pensions in payment would not be taxed, being equivalent to withdrawals from any existing fund of savings;
- Personal Equity Plans ("PEPs") and Tax Exempt Special Savings Accounts ("TESSAs") would be abolished and the proposals for Venture Capital Trusts would be dropped;
- ideally, bank and building society interest would be adjusted for inflation but, alternatively, capital gains would no longer be indexed;
- capital gains would be taxed as they accrued, rather than merely when they are realised;

- capital gains tax retirement relief and reinvestment relief would be abolished and the Enterprise Investment Scheme would be withdrawn;
- ideally, the annual capital gains tax exemption and personal allowances would be amalgamated;
- the annual benefit to an individual of home ownership (i.e. the saving net of mortgage interest as compared with what would be paid to rent accommodation) and capital gains on the sale of private residences would be taxed; and
- capital gains tax would be reintroduced for gains accrued at death.

These are major reforms. We could attempt some of them. The more fundamental and important changes, however, present enormous difficulties. Adjusting interest for inflation and taxing capital gains as they accrue can be done but are unlikely to be seen as practical options. There is no way actually to tax the accruing value of defined benefit pension schemes. Such changes pose tremendous transitional problems. For the UK, this does not seem a satisfactory direction to pursue.

Tackling Capital Gains Tax

If taxing all forms of saving in the same way involves so many difficult measures, can we nevertheless identify some less fundamental changes that would improve matters? Capital gains tax is generally regarded as the most unsatisfactory – and complex – element of savings taxation. The indexation of capital gains adds to its complexity and the decision to do away with relief for losses created or added to by indexation does nothing to reduce that complexity.

If we gave up indexing capital gains altogether the tax would be simpler. The failure to adjust the return on savings for inflation was, however, a major deficiency of the original tax, and the failure to give relief for indexation losses was a deficiency of the original indexation scheme. If our sole concern is simplicity, abolition of indexation is the most obvious step to take. This does not, however, address the main distortions created by the tax: indeed it adds to them.

Indexation, the annual exemption and other reliefs ensured that, in 1992–93, only 85,000 people were expected to pay capital gains tax. For many people capital gains arise infrequently rather than every year. The number of

capital gains taxpayers over time is therefore greater than the figure of 85,000 suggests. But it is still tiny as compared with around 25 million taxpayers. The yield of the tax is small and will be eroded further by existing and new measures.

If we wish to increase the yield of the tax and to eliminate the distortions in savings decisions that capital gains tax causes, we should adopt the measures outlined above. Most proposals for its reform, however, involve the *exemption* of gains provided the asset has been held for a specified period. Simplicity is achieved by exemption in the long run. A gain in the short term remains subject to tax. Short-term gains may be less affected by inflation but there is no logical distinction between short and long-term gains. Drawing such distinctions does not eliminate the complexity of the tax and leads to other distortions, such as the early realisation of losses, and creates a lock-in effect until exemption can be claimed.

One difficulty with capital gains is the variety of factors that go to create gains. If a gain arises from a risky but successful venture, many consider that the gain should be favourably treated because the government has a limited right to share in that outcome. Indeed, the taxation of capital gains is claimed to discourage risk-taking. On the other hand, where the gain represents the accrued value of untaxed income it is difficult to see why it should not be taxed as income.

The existence of so many persons in the savings market who are exempt from tax, coupled with the current imputation system of corporation tax, offers to taxpayers opportunities for tax arbitrage. As such, we can regard capital gains tax as one large anti-avoidance provision designed to prevent the erosion of the income tax base. Indeed, if capital gains tax were abolished, new and existing anti-avoidance provisions within the income tax could well add up to something very similar in effect to the existing capital gains tax.

Exempting Dividends

One way for the UK to move towards greater uniformity in savings taxation would be to withdraw the tax credit on dividends and *exempt* all UK dividends from income tax, other than the higher (40 per cent) rate. At present, dividends paid by UK companies carry a tax credit at the lower (20 per cent) rate. The tax credit is repaid to non-taxpaying individual shareholders, tax-exempt shareholders (such as pension funds, personal pension plan holders and PEP holders) and in part to treaty-protected foreign shareholders.

By abolishing the imputation system and exempting dividends from basic and lower rate tax, the UK government would raise additional tax, largely at the expense of exempt shareholders, who would no longer be repaid the tax credit. PEPs would lose one of their major attractions. Foreign shareholders would also lose out. Shareholders would pay further tax on their investment in the company only if they were higher rate taxpayers or discretionary trustees, or if their capital gains on sale as reduced by indexation exceeded the annual exemption limit.

For the most part, however, the government would collect tax on dividends by taxing the profits from which the dividends were paid. Effectively, we would have imposed a flat rate tax at the corporate rate on all shareholders. As the tax would be borne by all shareholders, including tax-exempt shareholders, there would be scope for removing shares from the capital gains tax charge or for reducing that charge to reflect merely the residual higher rate liability on undistributed profits.

We might not mind imposing a flat rate charge on shareholders on the assumption that the better-off have a larger part of their savings directly or indirectly invested in corporate equity. On the other hand, the additional tax suffered by pension funds would affect everybody. Unless we made other changes, pension funds would have an added incentive to invest in debt rather than equity.

How fair such changes would be would depend upon what the government did with the extra revenue it raised. What is more important, the tax on savings would depend significantly upon how companies' taxable profits were calculated, including the way in which relief was given for different financing costs.

Exempting Savings

The net effect of all the incentives summarised in the tables on pp. 16–19 is that the UK does not tax savings to any significant extent. Those individuals who still have savings tied up in their own homes are largely exempt from all tax. Pensions, PEPs, TESSAs and National Savings products are further examples of tax-exempt savings. The proposals for Venture Capital Trusts and the new Enterprise Investment Scheme add to the list of tax favoured savings products.

Taxing all or even most savings on the same basis rather than *exempting most* savings requires a radical upheaval in the way in which the present UK

tax system operates. Indeed, the only form of savings that the UK taxes consistently is ordinary bank and building society deposits, and then we over-tax the interest by not adjusting for inflation.

It is against this background that we make our proposal for EXPEP accounts in Chapter 4.

The Taxation of Institutional Investment: Pensions, Life Assurance and Collective Investment Schemes

Form of Savings	Taxation of the Individual Saver		Taxation of Financial Intermediary	
	Income	Capital Gains	Income	Capital Gains
Approved pensions schemes	Tax relief for contributions on salary up to £75,000 (1993–94) and £76,800 (1994–95). Pension taxable when drawn except for tax-free lump sum	N/A	Investment income exempt	Exempt
Funded unapproved retirement benefit schemes ("FURBs")	No relief for employee contributions. Employer contributions taxed on employee. Pension is taxable. Lump sums exempt unless scheme established offshore	N/A	Taxable	Taxable
Life assurance	Exempt if qualifying policy held for 10 years	N/A	Life assurance company taxable on income attributable to policy holders at the basic rate only	Life assurance company taxable on realisation
Friendly society assurance policies	Exempt if qualifying policy and annual premium £200 or less	N/A	Exempt	Exempt

The Taxation of Institutional Investment: Pensions, Life Assurance and Collective Investment Schemes *(Contd)*

Form of Savings	Taxation of the Individual Saver		Taxation of Financial Intermediary	
	Income	Capital Gains	Income	Capital Gains
Authorised unit trusts ("AUTs")	Nominal dividends taxed at lower and higher rates with tax credit for lower rate tax. Interest taxed at basic rate with credit for tax deducted by AUT	Capital gains taxed subject to reduction by indexation and annual exemption	AUTs' income taxed at 22.5% (25% 1994–95).UK dividends untaxed but lower rate tax credit is passed to unit holders on distribution	Exempt
Approved investment trusts ("AITs")	Nominal income taxable at lower and higher rates with tax credit for lower rate tax	Capital gains taxed subject to reduction by indexation and annual exemption	AITs' income taxed. UK dividends not taxed but lower rate tax credit passed to shareholders on distribution	Exempt
Offshore investment funds	Nominal income taxable (including gains on non-distributing funds)	Taxed subject to reduction by indexation unless non-distributing	May be taxable on UK source income	Exempt

The Taxation of Housing

Form of Savings	Taxation of the Individual	
	Income	Capital Gains
Rented housing	Nominal rent taxable (with full relief for interest on borrowings) but rent of up to £3250 p.a. on owner-occupied housing exempt	Taxable (with relief for inflation and up to £40,000 relief for let owner-occupied housing)
Owner-occupied housing	Imputed income untaxed and tax relief (at basic rate in 1993–94, lower rate in 1994–95 and 15% in 1995–96) for interest on £30,000 of borrowing	Normally exempt

The Taxation of Individual Shareholdings

Form of Savings	Taxation of the Individual	
	Income	Capital Gains
UK shares	Nominal dividends taxable at lower and higher rates with tax credit for lower rate tax	Capital gains taxed subject to reduction by indexation, the annual exemption, reinvestment and retirement reliefs
Foreign shares and securities	Nominal income taxable at lower and higher rates with credit for foreign withholding taxes	Capital gains taxed subject to reduction by indexation and reliefs as for UK shares
Shares in unquoted trading companies qualifying under the Business Expansion Scheme (up to 31.12.93)	Full income tax relief on up to £40,000 invested p.a. Nominal dividends taxable at lower and higher rates with credit for lower rate tax	Capital gains exempt if held 5 years. Income tax relief for acquisition cost and no relief for losses
Shares in unquoted trading companies qualifying under the Enterprise Investment Scheme (from 1.1.94)	20% income tax relief on up to £100,000 invested p.a. Nominal dividends taxable at lower and higher rates subject to credit for lower tax rate. Income or capital gains tax relief for losses	Capital gains exempt if held 5 years. Income or capital gains tax relief for losses
Shares or units held through a Personal Equity Plan	Dividends exempt and tax credit repayable; interest withdrawn without investment is taxed if above a *de minimis* limit	Exempt
Shares in unquoted trading companies held through a Venture Capital Trust (proposed for 1995)	Dividends exempt and tax credit repayable	Exempt

The Taxation of Interest-bearing Deposits and Securities

Form of Savings	Taxation of the Individual	
	Income	Capital Gains
Government securities	Nominal income taxable	Exempt (but accrued interest taxed as income)
Corporate sterling securities	Nominal interest taxable	Exempt (but accrued interest taxed as income and special rules for convertible, deep discount and deep gain securities)
Tax Exempt Special Savings Accounts ("TESSAs")	Exempt if within annual limit and if savings and basic rate tax on interest are retained in account for 5 years	N/A
National Savings	Some nominal interest taxable and some exempt	N/A
Bank and building society deposits	Nominal interest taxable	N/A
Post Office Ordinary Savings Account	First £70 of interest exempt	N/A

CHAPTER 4
EXPEP ACCOUNTS

PEPs and TESSAs

At present any UK resident adult can contribute up to £9000 each year to a Personal Equity Plan or "PEP". The amount contributed can be invested primarily in quoted UK and European shares, in units in authorised unit trusts and in shares in approved investment trusts. No tax relief is given on the amount saved, but dividends and capital gains arising within the PEP are tax free. The PEP holder is repaid the tax credit attaching to UK dividends. Withdrawals can be made at any time.

In addition, a UK resident adult can save up to £9000 over five years in a Tax Exempt Special Savings Account or "TESSA". Interest earned within a TESSA is tax free provided the capital (and a sum equal to the basic rate tax on the interest earned) is retained within the account for five years.

The EXPEP Account

Replacing PEPs and TESSAs

Personal Equity Plans and Tax Exempt Special Savings Accounts and a number of other measures have gone some way in recent years towards rationalising savings taxation in the UK. Their development in our view offers the best prospect for continuing that process and, over the longer term, for tackling the issues raised by institutional savings.

Our proposals envisage a single savings product – Extended Personal Equity Plans or "EXPEP accounts" – which merges PEPs and TESSAs. We could retain existing PEPs and TESSAs subject to the current rules. It is simpler, however, to integrate them into the new EXPEP accounts.

Investment of EXPEP Savings

Money saved in an EXPEP account could be invested in any form of financial asset – shares, corporate bonds, government securities, warrants, futures or cash deposits. Unquoted shares raise special issues with which we deal in

Chapter 7. EXPEP savings include ordinary bank and building society accounts. The individual is free to manage his or her own investments or employ another to do so. The investments must, however, be held in the name of a plan manager, just as shares and units are held within existing PEP plans or as many private portfolios are held by stockbrokers' nominee companies.

EXPEP Account Contributions

Under our proposals, all UK resident adults are allowed to save a specified amount each year in an EXPEP account. We envisage that the limit is initially equal to the aggregate of the existing PEP and TESSA limits.

Our more radical extension of the EXPEP idea is to allow everyone to save *any* amount in an EXPEP account. However, tax at the basic rate must then be deducted from any amount *in excess of* the annual contribution limit. Thus, if the fixed annual limit is £12,000 and an individual contributes £15,000 to an EXPEP account, the plan manager immediately deducts tax at 25 per cent (£750) from the excess of £3000 and pays it to the Inland Revenue.

At first sight, it looks very unattractive to give away 25 per cent of your savings just to obtain future exemption from tax for any income or gains earned on those savings. The individual is, however, allowed to credit the tax deducted against the tax payable on his or her earnings or other taxable income and gains. This is similar to the current advance corporation tax system for companies. The annual contribution limit represents an administrative simplification for most individuals. It also benefits older taxpayers with an existing stock of savings and lower taxable incomes. Above the annual contribution limit, the principle of exempting savings out of taxed sources is established.

This arrangement largely removes the "lock-in" effect of the current capital gains tax and any advantage that taxpayers gain by deferring tax liabilities. The more tax you pay now, the more you can save in an EXPEP account. If you take steps to reduce your tax bill, you reduce what you can save in a tax-free environment. However, a major lock-in effect remains if accrued but unrealised capital gains continued to be exempt from tax on death (see p. 53).

Tax Relief and Withdrawals

EXPEP accounts operate in the same way as PEPs: no tax relief is given on the amount contributed to an account but income and gains, in whatever

form, arising within the account are exempt. There is no restriction on withdrawals and no tax is charged on any amount on withdrawal.

Long-term Benefits of EXPEP Accounts

The proposal for EXPEP accounts builds on the existing PEPs regime. The exemption from tax for income and capital gains on EXPEP savings extends to all financial assets the treatment presently accorded to owner-occupied housing, shares held within a PEP and cash deposits in a TESSA, and assets held within a pension fund or personal pension plan. It should be immediately possible to simplify some of the detailed administrative arrangements that already surround PEPs.

Other forms of savings tax regimes can be allowed to wither and, if desired, be phased out as more savings are held within EXPEP accounts. It should be possible to rationalise and reduce tax legislation that currently has to establish the limits of various savings products and institutions. Eventually we will confer a uniform tax treatment on most savings.

This uniformity should enable more emphasis to be placed on the return offered by the particular form of financial asset rather than its particular tax characteristics and on the other, non-tax features of the particular product. A process already underway with PEPs should be completed with EXPEP accounts.

EXPEP accounts still involve financial assets being held by an institution in the form of a plan manager. But institutions already hold most financial assets. The important factor is that savings are wholly mobile between plan managers. Less is tied up as long-term institutional savings. The lock-in effect of limited PEPs and TESSAs is removed. Our savings are available as and when our personal circumstances require. We can simplify the existing PEP rules.

People should not be inhibited from owning and managing their own investments merely because they must be held by banks, building societies or other financial intermediaries acting as the equivalent of a stockbroker's nominee company.

Evaluating EXPEP Accounts

Our proposals achieve greater neutrality. As compared with the current system they are simpler, more transparent and offer administrative benefits

– ridding taxpayer and Inland Revenue alike of the need to be concerned with the complex capital gains tax rules. However, if the great majority of savings is held in EXPEP accounts and is exempt from tax, why not just abolish tax on investment income and gains? This would be simpler still.

We believe that such a course would confer too large a benefit on existing savings. Wealth, and therefore investment income and gains, is concentrated in the hands of a relatively small number of individuals. These individuals will clearly be able to take full advantage of EXPEP accounts. However, an annual limit ensures that a proportion of financial assets, generally owned by the better-off, remains outside EXPEP accounts.

Our proposal to allow unlimited amounts into EXPEP accounts offers individuals the option to live off their existing savings while saving their earnings in an EXPEP account. As such, it represents a satisfactory way in which to manage the transfer of existing savings into EXPEP accounts, while in the long term ensuring that savings above the annual contribution limit can only come from *taxed* sources.

Essentially, our long-term aim is for *the return on savings out of taxed income or gains to be tax free*. We no longer penalise individuals just because they chose to save rather than to spend their earnings. Savings made from gifts or inheritance or which are derived from abroad remain the major sources of taxable savings because they are derived from untaxed (or non-UK taxed) sources.

Overall, we think that this system is fairer. As matters stand, the return on savings is not taxed to any significant extent. This is not just a matter of accident but a reflection of the impact that taxation is thought to have on levels of savings and investment and of the practical difficulties involved. Those difficulties are found in many other tax systems and are unlikely to disappear. Quite the contrary – taxing savings becomes more difficult with the increasing access to international capital markets in general and the Single European Market in particular.

The form of savings that is currently overtaxed is interest on ordinary bank and building society deposits. It is easy to identify and to tax. But the mechanical ease that enables government to resort to this form of savings to raise taxation does not justify taxing it with no adjustment for inflation. It is the form of savings best suited to the needs of lower income groups who are risk averse and want immediate access to their savings. These groups should benefit most immediately from the introduction of EXPEP accounts.

CHAPTER 5
TAXING PROFITS

Taxing Companies

Why Tax Companies?

No proposal for savings would be complete without some consideration of the taxation of profits. Most savings ultimately flow into companies. Companies earn profits from their business activities and those profits provide the return that the saver seeks. Corporation tax can be viewed, in part at least, as a tax on savings. But if a large part of personal savings is exempt from tax, why tax companies at all?

To give up taxing companies would unnecessarily benefit shareholders who bought their shares at a price reflecting the assumption of continued taxation. We need good reasons before we confer windfall gains on such persons. But there are better reasons than that for retaining corporation tax. A company's profits represent more than just a return on the capital invested in it. In particular, they reflect the "economic rents" earned by the company. Profits earned by small companies include entrepreneurial earnings, a subject to which we return in Chapter 7.

Economic Rents

We use the term "economic rents" to refer to the *extra* profit that a company earns after paying all its costs. For these purposes, a company's costs include the payment of whatever market rate of return is necessary to attract *equity* investment in the business.

Imagine that a company announces that it will pay dividends at a minimum specified rate. The rate it sets is the market rate of return that its shareholders expect to earn elsewhere at equivalent risk on the capital that they provide to the business. Each year the company pays dividends at that rate. In that case we could allow the company to deduct the dividends in working out its taxable profits and, if we wanted to, tax shareholders on their dividends. Dividends would be treated just like interest on the company's borrowings. What the company would be left with would be its "economic rents".

Risk obviously affects the required rate of return on equity investment. However, for a variety of reasons a company may be able to earn more profits than the price it pays for the elements of its production – including its capital requirements. The company may, for example, be closer to its markets so that its costs are lower than its competitors and it can make more profit on what it can charge for its products. Similarly, the country in which it operates may have better infrastructure or cheaper labour. The company may be better managed, more innovative or better able to exploit new technology. It may be a monopoly producer.

Of course, companies do not pay dividends on that basis. Shareholders earn a return on their investment as a mixture of dividends and capital gains. Taxing retained profits is a substitute for taxing shareholders on that return. The company's economic rents, after tax, belong to those individuals who are fortunate enough to be the company's shareholders at the time. If they sell their shares they can demand a price that reflects not only the profits that the company has already earned and retained, but one that reflects expectations as to its ability to earn economic rents in the future. These are factors that create capital gains.

These concepts are easier to understand for publicly quoted companies that must compete in an established and sophisticated market for their capital requirements. They are more difficult to appreciate in the case of small unquoted companies that need to raise venture capital. We return to this in Chapter 7.

Company and Shareholder Taxation

The Assumed Shareholder Tax Rate

As we saw on p. 13, if we exempt dividends from tax, corporation tax becomes a final flat rate tax on all shareholders. At the moment, however, the UK taxes dividends according to the circumstances of the shareholder, giving credit for part of the corporation tax paid against the shareholder's own tax liability on the dividend.

The current corporation tax assumes that shareholders pay income tax at the lower or basic rates – 20 and 25 per cent respectively. With the tax credit, basic and lower rate taxpayers normally pay tax at an effective 33 per cent rate on the company's profits. Ignoring the small companies' rate of corporation tax (see p. 41), this remains the same whatever the level of those profits and however much (or little) is paid as dividends.

However, the typical holder of quoted equity is entitled to be repaid some of or all the tax credit. By 1992, individuals held only 20 per cent of publicly quoted shares, as compared with 54 per cent in 1963. Exempt shareholders now dominate the market for quoted equity. For them the effective rate of tax on retained profits is 33 per cent and on distributed profits it is 13 per cent, being the difference between the corporation tax rate and the rate of tax credit.

As a result, the higher the dividends paid, the lower the effective tax rate on corporate profits. It is precisely the opposite for higher rate taxpayers – the higher the dividends paid, the higher the effective tax rate. But higher rate taxpayers represent a small part of the market for quoted equity. The market is driven by tax-exempt shareholders.

Distributed and Retained Profits

In general, therefore, retained profits are *over taxed.* On the other hand, tax on distributed profits may be repaid to exempt shareholders even though it is attributable to the company's economic rents. But we do not have to repay the tax on these rents, whether the company retains or distributes them. A tax on economic rents should not discourage a company from earning those rents because they reflect more profits than the company's shareholders could reasonably have expected to earn on their money elsewhere. For the same reason, the tax should not discourage shareholders from financing a company that provides more profit than they initially expected.

Accordingly, a company's investment and financing decisions are largely unaffected by a tax on its economic rents.

Corporate Investment

Calculating Profits

At present, corporation tax purports to tax profits including the shareholders' return on capital and not just the company's economic rents. We speak glibly about taxing a company's profits or its economic rents as if these were easy to measure. But they are not.

To measure profits accurately we need to ascertain with precision the true rate at which business assets *depreciate;* we also have to know the rate at

which profits accrue to the business; what impact, for example, advertising expenditure has on the value of the goodwill of the business and on its profit-earning capacity. We should also adjust profits to eliminate the effects of inflation. All of these are difficult and we can achieve none of them with accuracy.

Accountants face similar problems in devising rules to measure accounting profit. At present, to arrive at *taxable* profits, UK tax rules start where the accountants have left off. Various special rules are then adopted to produce a figure that is called "profit" for tax purposes.

The Role of Tax Incentives

Tax rules (just as accounting rules) may over or underestimate the company's true profits. Capital allowances for tax purposes differ from both accounts depreciation and what would be true economic depreciation. Indeed, they may be designed to overestimate depreciation as an investment incentive.

Incentives need to address specific objectives and the tax system should be an efficient and effective means of achieving those objectives. While the tax system may alter the *timing* of investment, there is little satisfactory evidence to show that it increases the overall *amount* of investment. More often, the relief benefits investment that would have been made anyway or directs resources towards less productive investment.

Appreciating Assets

The rules also fail to measure accurately, or at all, the unrealised *appreciation* in the value of assets. The failure to measure accurately either depreciation or appreciation affects the time at which profits are recognised for tax purposes and so alters the effective rate at which tax is charged on profits. As a result the company has an incentive to favour assets that are overdepreciated through capital allowances and appreciating assets where no account is taken of the appreciation until it is realised.

In short, taxation affects the amount and timing of a company's investment decisions and the choice of asset in which to invest, but not necessarily in ways that are either beneficial or productive.

Financing Activities

The Deduction of Interest

The system also influences the way in which a company finances its activities and assets. If the company borrows, it deducts the costs of doing so in working out its taxable profits. The development of new financial instruments often means that a company's nominal interest payments are no guide to its true costs of finance. Nevertheless, because no adjustment is made for the fall in value of its liabilities through inflation, a company may get relief for inflation twice – once by deducting its nominal costs of finance and, again, through the indexation for capital gains purposes of the costs of its assets.

We might anticipate that the deduction of the nominal costs of finance is balanced by their taxation in the hands of the recipient. In fact, this is often not so. Pension funds and similar lenders are exempt. Where the lender is a bank only its margin is taxed as part of its profits. Interest on finance raised in the international capital markets must normally be paid gross and is largely untaxed.

Retained and Distributed Profits

Equity capital is taxed differently. As we explained on p.26, retained profits are taxed at up to the full corporation tax rate of 33 per cent while distributed profits are frequently only taxed at the difference – 13 per cent – between the corporate tax rate and the tax credit rate. As more and more equity is held by tax-exempt shareholders, the tax incentive to distribute profits increases.

Surplus Advance Corporation Tax

The fact that debt and equity, retained and distributed profits are all taxed differently plays a significant part in companies' financing decisions. However, if a UK company earns a large part of its profits abroad and pays foreign rather than UK tax, its decisions may be distorted further. When a UK company pays a dividend it must pay advance corporation tax ("ACT") to the Inland Revenue. This can be credited against the company's eventual corporation tax liabilities. But if the company's UK tax is insufficient because most of its tax is paid abroad to foreign governments, the ACT represents an additional tax liability. In essence, if the company earns its profits in the UK, tax is paid once. If it earns its profits abroad and retains

them, tax is paid once. But if it earns its profits abroad and distributes them, it pays tax to both the foreign Revenue authority and to the UK Revenue.

The charge to both UK and overseas tax can be avoided if the dividend is paid after 1 July 1994 as a "foreign income dividend". In that case, the company must still account for ACT but can reclaim the ACT wholly or in part if it shows that the dividend was paid out of foreign income that had borne an appropriate rate of foreign tax.

Directions for Reform?

Exempting Dividends and Disallowing Interest

The difficulty of measuring profit, the tax adjustments to reported accounting profits and the need to distinguish different types of asset and to draw lines between different forms of finance, all add to the complicated detail of corporation tax. The ability to pay foreign income dividends addresses the problem of surplus ACT. Overall, however, we are still some way from our ideal, under which companies invest in those assets and activities that they expect to be the most productive and finance that investment in the most efficient manner, in each case without regard to the way in which the investment, or the method of financing it, is taxed.

There are no easy solutions to these issues and problems. Calculating profits is always likely to be an art rather than a science. Exempting dividends and withdrawing the tax credit, as we outlined on p. 13, means that retained and distributed profits are taxed more equally. Indeed, the ability to pay foreign income dividends is consistent with this approach. Such dividends carry no tax credit and are exempt from basic rate tax. This makes them unattractive to tax-exempt shareholders so long as they can still receive ordinary dividends with a tax credit.

If all dividends are exempt from the lower and the basic rate tax and the tax credit is withdrawn, equity finance continues to be disadvantaged relative to debt. That bias is removed if no deduction is allowed for financing costs and interest is similarly exempt. This secures a consistent treatment of different forms of finance but, so far as debt finance is concerned, may merely increase the cost to the company of such finance. Overall, such an approach would have a substantial impact on existing pensions, as well as everyone with an interest in a pension fund, personal pension plan or PEP.

Alternatives to Taxing Profits?

Changing the way in which dividends or interest are treated does not alter the difficulties involved in calculating profits. Is the solution, therefore, to abandon altogether the attempt to tax profits. A flat rate charge on companies based on some other measure – such as capital employed or particular asset values – or on what the company produces – as in the case of the Insurance Premium Tax and Air Passenger Duty – might raise more revenue with a greater degree of certainty as to the company's tax burden. The tax cost could be allowed for in pricing its goods or services or setting wage rates.

Such measures may merely perpetuate competitive disadvantage, distortions in behaviour and economic costs. Taxing a proper measure of profit allows us to relate the tax burden to a company's ability to pay without affecting its position relative to other competitors for its goods and services. Once we have such a measure of profit we can tax it and raise revenue in doing so without unnecessarily distorting companies' decisions. It is with this end in mind that the proposals we make in Chapter 6 are directed.

CHAPTER 6
THE ACE CORPORATION TAX

The ACE Concept

The Objective of the ACE Corporation Tax

The objective that lies behind the ACE corporation tax is quite simply to provide a measure of profit that can be taxed without distorting a company's investment and financing decisions. Our proposal for achieving this is straightforward. In working out its taxable profits, a company would be entitled to deduct an allowance for the capital invested in it by its shareholders. We call this Allowance for Corporate Equity, the company's "ACE allowance". To work out its ACE allowance, each company creates a record of the money provided to it by its shareholders. We refer to this as the "Shareholders' Funds Account" or "SFA".

The Shareholders' Funds Account

For most companies, shareholders' funds comprise two main elements:

- the amounts subscribed for new share capital, and
- retained post-tax profits.

Adjustments to the SFA are in nearly all cases by reference to *actual* payments or receipts of money or value by the company. Amounts subscribed for new share capital are, for example, added to the SFA when subscribed. Dividends are deducted when paid. The balance is adjusted for retained post-tax profits when tax is paid or repaid. The table on p. 33 sets out details of the main payments and receipts that affect the SFA balance.

The SFA works as any ordinary loan account for money borrowed by the company. The company calculates its ACE allowance as a bank calculates interest on an overdraft. In contrast to an overdrawn account, however, shareholders' funds for most companies will change infrequently during an accounting period.

The ACE Rate of Interest

At the end of each accounting period, the company multiplies the daily balance of its SFA for the period by a published rate of interest. We call this rate the "ACE rate" to be published monthly by the government. The ACE rate is based on market interest rates for medium-term government securities and varies in line with such market interest rates.

Deducting the ACE Allowance

The figure that this calculation produces is the company's ACE allowance. It is deducted in working out the company's *taxable* profits for the period. If no profits are made, or if the ACE allowance turns a profit into a loss, relief can be given for the loss in a similar way to that for excess interest on debt finance.

Implementing the ACE Corporation Tax

Legislative Changes

In the UK, new legislation is required to provide the rules for calculating the SFA and the ACE allowance. A number of detailed amendments are also needed to existing legislation. The principal changes include the following:

- Dividends received by one UK company from another are at present exempt from tax, but capital gains on the disposal of shares are not. Under the ACE corporation tax, both dividends and capital gain on shares are exempt (as they are for individuals under a PEP). Purchases and sales of shares and dividends paid and received lead solely to cash adjustments in the SFA balance (see the table on p. 33). We propose that this treatment should normally extend to investment in foreign companies (see p. 50).
- As the ACE rate is based on nominal interest rates, the ACE allowance gives relief for inflation against the company's net assets. Specific indexation of the costs of a company's capital assets can be abolished.
- The company need no longer pay ACT on dividends; dividends no longer carry a tax credit. This is because the equivalent of a tax credit is given automatically to the company (rather than to its sharehold-

SHAREHOLDERS' FUNDS ACCOUNT

The closing balance of the SFA in the previous period
\+ the ACE allowance for the previous period
= the opening balance for the period

Additions during a period include:

\+ Profits on which tax is paid during the period
\+ Proceeds of new equity issues
\+ Dividends received from other companies
\+ Amounts received on the disposal of shares in other companies
\+ Tax repaid during the period on an adjustment of taxable profits

Reductions during the period include:

– Tax paid during the period on taxable profits
– Dividends paid and other distributions made
– Capital repaid or shares repurchased
– Amounts invested in shares of other companies
– Profits in respect of which tax is repaid during the period

ers) through the exemption from corporation tax of profits covered by the ACE allowance.

- Tax is deducted from dividends at the basic rate of income tax (or the treaty rate for non-residents); dividends can be paid gross to UK companies and to tax-exempt shareholders (including EXPEP account managers).

The abolition of the advance corporation tax system, the exemption of investment in other companies and the removal of capital gains indexation considerably simplifies corporation tax legislation. Companies must maintain a Shareholders' Fund Account and calculate the ACE allowance, but many of the rules for these can be based upon existing tax legislation without additional complication.

The Calculation of Profits

The company's profits can be calculated under existing rules, accepting their arbitrary nature. However, under the ACE corporation tax this arbitrariness loses much of its importance. If tax rules *over-estimate* profits, the compa-

ny's current tax liabilities are increased. But it receives a *higher* ACE allowance in future. On the other hand, if current tax liabilities are reduced because tax rules *under-estimate* profits, the ACE allowance is *lower* for the future. The cash flows may be different but, in present value terms, the business is in the same position whether profits have been under or over-estimated by the tax system.

This result is an important effect of the ACE corporation tax. It is of much less significance to the company whether it defers profits or realises them immediately. In either case shareholders' funds are increased by post-tax retained profits. If it realises profits, its shareholders' funds are increased and it gets higher future ACE allowances (and lower taxable profits). If it defers profits, future ACE allowances are lower (and taxable profits higher).

One of the major problems of calculating profits – the timing of their recognition – is accordingly removed. At the same time, if profits are increased merely as a result of inflation, the company obtains relief for that increase through the increase in its shareholders' funds on which a larger ACE allowance accrues. The ACE allowance, as interest on corporate debt, is calculated at a *nominal* rather than an inflation adjusted rate. It thus compensates for the effects of inflation by giving relief for the decline in value of the assets financed by the shareholders' capital.

Using Accounts Profits for Tax Purposes

None of this means that we do not care how profits are calculated under the ACE corporation tax. Inaccuracies may matter rather less but, ideally, we would still like profits to be measured as accurately as possible. As the best practical measure available, we would take the opportunity that the ACE corporation tax offers to base profits for tax purposes more closely upon companies' reported accounting profits.

This should simplify tax computations, e.g. by allowing the depreciation shown in the accounts to be used rather than a special system of capital allowances. It should also reduce taxpayer compliance costs and ensure that a company's tax position matches more nearly its reported commercial and financial position. There is scope for simplifying loss reliefs.

The ACE allowance does not represent an amount that has passed through the company's books. We would, therefore, require companies to state the balance of their Shareholders' Funds Account as a note to their statutory accounts.

The Benefits of the ACE Corporation Tax

The Effect of the Tax

The ACE corporation tax does two things:

- it gives the *company* (rather than its shareholders) a tax credit through the ACE allowance;
- the tax credit is, however, limited to the ACE rate on shareholders' funds.

This tax credit represents an ordinary risk-free rate of return on what the shareholders have invested in the company. The ACE corporation tax taxes economic rents, including the risk premium on equity capital, earned by the company – i.e. what the company earns above its ACE allowance.

Corporate Investment and Financing

As the tax falls principally on companies' economic rents, it should not distort their behaviour to any significant degree. Companies (and their shareholders) should always prefer to invest in those activities and assets that generate taxable profits rather than those that do not.

Because the ACE corporation tax adjusts profits for inflation and treats all assets and activities equally, companies are free to invest wherever they believe it to be most profitable to do so. In addition, by giving the company a deduction for equity capital, the tax treats new equity, retained profits and borrowings in the same way. The surplus ACT problem disappears. Tax considerations should play a smaller part in companies' decisions how to finance their investments.

Institutional Savings and Investment

The adoption of EXPEP accounts achieves over time a greater degree of uniformity in the institutional savings market. This process is completed by the ACE corporation tax. Intercompany dividends are already exempt from the tax and under the ACE corporation tax, capital gains on the realisation of intercorporate shareholdings are no longer taxed. Institutional holdings of savings accordingly become largely tax exempt. Tax is borne at the company level on the company's economic rents without credit to its shareholders (institutional or otherwise) for the corporate tax paid. Any additional tax on

the return to savings is imposed at the shareholder level as those savings are withdrawn or realised.

Shareholder Taxation

Relationship to PEPs and EXPEPs

As we explained on p. 25, the current corporation tax works on the basis that shareholders pay income tax at the lower or basic rate. But rather more are exempt from tax than pay tax at those rates. Whether PEPs continue in their present form or are converted into our proposed EXPEP accounts, the proportion of exempt shareholders is set to increase.

The ACE corporation tax assumes that shareholders are exempt. For tax-exempt shareholders, the tax rate on corporate profits remains the same whatever the level of dividends paid, as contrasted with the existing imputation system (see p. 25).

Taxable Shareholders

Even with EXPEP accounts not all shareholders will be exempt; a minority will continue to be taxable. With the ACE corporation tax, that minority benefits from being able to roll up profits at the ACE rate free of corporation tax. We could, therefore, consider abolishing the indexation of share costs for capital gains tax purposes. This allows us to simplify significantly the capital gains tax legislation. Taxable shareholders would be taxed on both their nominal dividends and nominal capital gains, without credit for tax paid by the company. Tax paid by a shareholder would merely be postponed until profits were withdrawn from the company or realised without reinvestment (see p. 42).

The withdrawal of capital gains tax indexation relief for share investments could result in some shareholders being over-taxed once inflation is taken into account. However, our ultimate objective is for the majority of savings to beheld in EXPEP accounts. Taxable savings are restricted to existing savings yet to be transferred into an EXPEP account and new savings from untaxed sources. We think that any over-taxation, mitigated by the postponement of tax until withdrawal or realisation without reinvestment, is an acceptable price to pay for the greater simplicity of an unindexed capital gains tax.

At first sight, the company appears to have an incentive under the ACE corporation tax to retain rather than to distribute profits; shareholders to have an incentive to retain rather than to sell their shares. Neither is true if, as we propose, shareholders can save any amount in an EXPEP account out of post-tax income and gains (see p. 21).

Finally, however, we need to consider whether this method of taxing shareholders is satisfactory for those who have invested in small, high-risk, unquoted companies. This leads to a consideration of how venture capital ought to be taxed. We look at this in the next chapter.

CHAPTER 7
VENTURE CAPITAL

Entrepreneurial Reward

The Cost of Quoted Equity Capital

In Chapter 5 we asked why we might want to tax companies at all. One reason for doing so is because a company's profits may include economic rents that we can tax without affecting the company's decisions. We use the term "economic rents" to refer to the extra profit that a company earns after paying all its costs, including the cost of attracting equity capital (see p. 24).

Companies range from the largest, publicly quoted, multinational corporations to the one-person company. The same basic tax rules apply to them all but they each give rise to very different considerations. This becomes apparent when we compare the cost of equity capital to the publicly quoted company with that for the unquoted family company.

Those who invest in quoted shares, whether directly or through an institutional savings plan, pay a price to do so based on the market's expectations of the ordinary return that the shares will yield on the amount invested for the risk involved. Share prices fluctuate due to a variety of short-term factors. In the *long run*, however, if a company performs better than expected and, in particular, if it is expected to maintain its performance, this emerges in an increase in its share price.

Those who have already invested in the company are then able to realise additional capital gains on selling their shares. New investors buy the shares at the higher price, reflecting what the market now thinks is the right price for new investors to pay to earn a market rate of return on their investment.

Economic Rents and Unquoted Companies

This indicates that the concept of an implied cost of equity capital has meaning in the context of a publicly quoted company. However, what is the implied cost of equity capital invested in an unquoted company? Entrepreneurs invest in their companies because, as proprietors, they believe that they are better rewarded by their own efforts than by those of others. Venture

capitalists invest in such companies on the basis that they share in those rewards.

Each invests because they believe that they can do better (after taking account of taxation) than elsewhere at equivalent risk. We can therefore ask what return on their investment would they each require to be persuaded to invest elsewhere? The venture capitalist's answer to this question may depend crucially upon the risks involved in different investments. Part of the entrepreneur's answer may depend on what he or she could earn in another occupation, were one available.

The entrepreneur's alternative is to take a job and save capital in more conventional ways at less risk and for lower reward. From this we can appreciate that the profits that an entrepreneur makes through the company are a blend of earnings and return on capital invested. In such cases, economic rents, entrepreneurial earnings and the risk premium on equity capital shade indistinguishably one into another. Ideally, we would like to see each element of profit taxed identically.

The Taxation of Earnings

We may earn our living as another's employee, through self-employment or as a proprietor/manager of a company. Individual views differ on the value that each occupation contributes to the general good of society. However, the financial rewards that an occupation brings are generally unrelated to the occupation's perceived social value. Many may think that tax specialists do not contribute a great deal to the general good. But they are normally better rewarded financially than nurses who are more highly regarded.

It is inappropriate to make value judgements through the tax system about particular earnings – whether some are more meritorious than others. Ideally, therefore, our starting point is that those who receive similar earnings should bear similar tax burdens. It is difficult, however, to achieve the ideal of taxing a self-employed person's profits in the same way as an employee's wages, and entrepreneurial earnings in the form of corporate profits in the same way as the profits earned by the self-employed. And in several cases the tax system explicitly favours some earnings, often based on the particular risks or incentives that are thought to attach to the rewards in question. Thus, employee earnings through share incentives are favourably treated; there is tax relief for profit-related pay; and entrepreneurial earnings may be exempt through capital gains tax retirement relief.

The Taxation of Entrepreneurial Reward

Taxing entrepreneurial earnings presents particular problems. It should not matter whether an entrepreneur:

- withdraws earnings as salary that is taxed solely in his or her hands, or
- withdraws earnings as dividends, with tax collected initially from the company and the final liability settled by the entrepreneur as shareholder, or
- retains his or her earnings in the company for further investment so that they are taxed solely in the company's hands, subject to any further tax on the capital gains that the entrepreneur may eventually pay on the sale of the shares.

The mere statement of these alternatives illustrates the difficulty of achieving a similarity of result in each case. And the outcome under the present tax system certainly differs depending upon the way in which the entrepreneur chooses to withdraw profits. A feature of our proposals is to offer the opportunity of far greater uniformity in the taxation of earnings generally and entrepreneurial earnings in particular.

Unquoted Shares as EXPEP Assets

The Inclusion of Unquoted Shares in EXPEP Accounts

Unquoted shares are generally not a permitted PEP investment. This reflects a concern that proprietors of private companies could secure exemption from tax for their earnings by paying them through a PEP as dividends with the benefit of a repayable tax credit. From 1995, PEP-type treatment is proposed to be extended to investment in unquoted shares through Venture Capital Trusts. These trusts are likely, however, to operate under closely controlled conditions, designed to attract new third party capital rather than to benefit capital contributed by existing proprietors.

Under the ACE corporation tax, however, dividends no longer carry a tax credit. It becomes possible, therefore, to allow equity capital invested in an unquoted company by its proprietor to be held within an EXPEP account. Interest relief would not be available on any loan taken out by a proprietor to finance investment in shares held through an EXPEP account.

The Impact of the ACE Corporation Tax

On p. 36, we explained that the ACE corporation tax enables the company to accumulate free of corporation tax profits up to the risk free rate of return on shareholders' funds – as represented by the company's ACE allowance. Shareholders who remain liable to pay tax on dividends and capital gains, will do so on those accumulations only when they withdraw or realise them.

Small and medium-sized companies benefit from this reduction in tax on retained profits. We would therefore withdraw the small companies' rate of corporation tax. When the current corporation tax system was introduced in 1973, the small companies' rate was devised to shield unquoted companies that rely more heavily on retained profits from the higher corporation tax rate under the imputation system. This is no longer necessary.

There is also sense in setting the corporation tax rate in line with the top personal rate of income tax. Leaving aside National Insurance contributions, an entrepreneur whose personal income tax rate is below the corporate tax rate can draw salary, deduct the salary from the company's profits and pay tax at personal income tax rates. Any unspent post-tax earnings can be reinvested in the company through an EXPEP account. Once an entrepreneur faces the top rate of income tax, it no longer matters whether earnings are retained or withdrawn as salary or as dividends. As a result, profits attributed to the capital invested or retained in the business by the entrepreneur are exempt from tax, provided they have come from taxed sources. The element of profits representing entrepreneurial earnings is always taxed at the entrepreneur's personal tax rate.

Shares Held Outside an EXPEP Account

The Choices for Shareholders

The ACE corporation tax enables unquoted shares to be held in an EXPEP account. Nevertheless, it may be some years before the majority of existing unquoted equity investment is held in this way. In the meantime, dividends withdrawn and capital gains realised on shares that are held outside an EXPEP account remain fully taxable. Is this a satisfactory result in the case of unquoted shares?

Individuals who hold equity investments outside an EXPEP account face two choices under our system: they can:

- withdraw or realise profits now, pay tax and secure exemption for the future on any profits they reinvest through an EXPEP account: or
- defer withdrawal or realisation of the profits, pay no tax but leave those and future profits subject to tax.

The ACE corporation tax also allows an individual to withdraw dividends or sell investments and reinvest the proceeds without an immediate tax charge by doing so indirectly through a personal investment company. Eventually, however, the individual must pay tax on any amounts withdrawn from the personal investment company or on the realisation of any gains on the shares in the company.

Reinvestment Relief

The first option – to pay tax on current income and gains but thereby securing a tax-free return on any amount reinvested through an EXPEP account – is an attractive enough option for ordinary savings in relatively low-risk forms, such as quoted securities and ordinary cash deposits. However, the prospect of future tax-free returns – even high ones – for tax paid now, may be less attractive to an individual if the investment is a high risk one that may as easily fail as succeed.

By continuing to defer income and gains (and the tax on them), an individual allows the government to continue to share in a successful outcome at whatever tax rate applies at the time when those profits are taken. On the other hand, the individual also leaves open the prospect that if the venture fails, the government shares in that failure by forgoing the tax that it would have collected now had tax been paid.

We would therefore retain the reinvestment relief introduced by the Finance Act 1993 and extended in the 1994 Finance Bill. This should restrict the growth of personal investment companies solely as a tax planning tool. Tax is deferred on any capital gains that are reinvested in 5 per cent or more of an unquoted trading company.

We would lift the many restrictions on the companies whose shares qualify for reinvestment relief and would replace the new Enterprise Investment Scheme by further extending reinvestment relief to tax due on other income. Tax on such other income could be deferred and the allowable cost

of the shares acquired restricted as a result. But, as previously explained, individuals who choose to defer tax, limit the amount that they can save in an EXPEP account and leave open the prospect of a future tax charge on any nominal dividends or capital gains withdrawn or realised.

Retirement Relief

If we wished, we could withdraw capital gains tax retirement relief. Reinvestment relief, coupled with the ability to save in an EXPEP account any amount from taxed sources, are sufficient reliefs. However, a measure of retirement relief may still be thought appropriate, given favourable treatment of share options and profit-related pay for those in employment, and the ease with which holders of quoted securities – as contrasted with holders of unquoted shares – can take the benefit of any capital gains annual exemption.

Unincorporated Businesses

We have described the ACE concept as a way of taxing corporate profits. But it applies equally to unincorporated businesses. Relief can be given for the taxed profits that self-employed persons retain in their businesses just as it is for retained corporate profits.

To receive an ACE allowance for the proprietor's funds in an unincorporated business, one of two things is required, either:

- business accounts must be prepared, sufficient to identify the capital contributed to the business by its proprietors and their drawings from it – the unincorporated business equivalent of the SFA, or
- the proprietor has to provide capital for the business through an EXPEP account.

If the second option is adopted, the ACE allowance is calculated by reference to the balance of the EXPEP account invested in the business over the accounting period. The EXPEP manager becomes responsible for ensuring that the account is properly run. Proprietors' capital on which interest relief is claimed would be excluded from these arrangements.

Conclusion

In this chapter, we have explained that:

- in the case of a small unquoted company, corporate profits include entrepreneurial earnings as well as a return on capital invested in the business and the company's economic rents; and
- ideally, we should try to tax entrepreneurial earnings, a self-employed person's profits and an employee's wages equally.

The combination of EXPEP accounts and the ACE corporation tax allows us to go a substantial way towards achieving this. In addition, the facility to save unlimited amounts from taxed sources in an EXPEP account, coupled with an extended reinvestment relief, provides a satisfactory regime for dealing with unquoted share investment.

We now need to consider how our proposals fare in an international setting.

CHAPTER 8
THE INTERNATIONAL PERSPECTIVE

Open Capital Markets

Savings and Investment Decisions in Open Markets

It is difficult enough to design a satisfactory tax system in a domestic context. But the difficulties increase tenfold in an open economy, where capital may flow freely between countries. Individual and company decisions are influenced not only by the UK's tax system, but by tax systems across the world and in the European Union in particular. Several countries may lay claim to tax the same capital but may have difficulty in enforcing their claims as competition for capital, its mobility and the administrative difficulties of taxing it undermine their attempts to do so. As a result, capital may be diverted from the most economically productive investments.

Distortions within the European Union

The elimination of trade barriers within the European Union emphasises the distortions that tax systems can produce. Different corporate tax systems, coupled with different tax incentives, may lead to capital being attracted to investments that are less productive before tax but which earn a better *post*-tax return than competing, more productive investments. This may lead to an overall loss in economic efficiency within the European Union.

This is equally true outside Europe as trade barriers come down. But the allocation of investment capital to the most productive uses may not be a principal concern of governments in a world in which countries compete for investment capital, often through the medium of the tax system. However, it should be a major concern to those European countries that are part of, or aspire to join, the Single Market.

Differences in Member States' tax systems also inhibit the development of equity markets within the European Union. They affect the ability of European-based companies to attract capital and to compete with each other, and with those from outside the Single Market. A Committee of Independent Experts on Company Taxation – the Ruding Committee – appointed by the

European Commission in 1991, examined these issues and concluded that corporate taxes *do* distort the functioning of the Single Market.

Tax Treaties

Open international markets expose the structural weaknesses that exist in the relationships between different tax systems. These weaknesses do not necessarily reflect inadequacies in particular tax systems. They merely illustrate that tax systems are moulded to meet the policy objectives of national governments. In an open international environment, tax systems are as likely to fit together as a selection of pieces drawn at random from a jigsaw. The international tax system lacks a single dominant tax policy-maker to sort out its problems.

The international tax treaty network attempts to address some of these issues. Treaty networks concentrate on the elimination of double taxation, the allocation of the tax base between contracting countries and the enforcement of tax liabilities. Treaties are, however, an inflexible instrument with an average life of over 14 years. They may inhibit domestic reform or be rapidly rendered out of date by changes in national tax systems. They become part of the structural weakness that is played upon by taxpayers through treaty shopping, resulting in ever more complex anti-abuse provisions.

Residence and Source Country Taxation

Double taxation of international investment capital arises because two countries – the country that provides the capital (the "residence country") and the country in which it is invested (the "source country") – compete to tax the return on that capital. Bilateral double taxation agreements offer a way for the two countries to agree on how they will split the tax. However, the bargaining position of each country depends upon the strength of its claim to tax the capital.

A residence country's claim to tax relies on the fact that the person who ultimately owns the capital belongs in its jurisdiction. In the final resort, it can tax the profits that the capital produces when that person eventually repatriates them. The source country relies on the fact that the capital is invested in its jurisdiction. Taxing company profits gives the source country the first bite of the cherry.

However, a tax on the profits that inward investment produces is a tax on the commodity that the source country seeks. If taxation raises the price that

its enterprises pay for capital, the source country gains little from taxing it. Domestic profits, and the international competitiveness of the country's enterprises, are merely reduced by the price they must pay. The source country also gains nothing if the capital is attracted elsewhere as a result of more favourable tax regimes in other countries.

The source country tax can safely tax profits without deterring inward investment in three cases. The first is if all other countries tax profits on a similar basis. But as countries normally wish to encourage inward investment, they are more likely to seek ways of making their tax systems more attractive than to strive for uniformity with other countries. A residence country can make it easier for a source country to tax the profits produced by inward investment by allowing a credit for the source country's taxation against the tax otherwise due in the residence country, or by exempting foreign profits that have been taxed elsewhere. However, a residence country will not normally give credit for more foreign tax than it would otherwise charge itself. Generally, residence countries also find it difficult to tax profits earned abroad until they are repatriated.

The second case is this. Whatever other countries do, a source country can tax inward investment that cannot migrate elsewhere. Nevertheless, high taxation may still discourage future inward investment. The differential treatment of direct equity investment and internationally provided debt capital illustrates these first two cases:

- the mobility of debt capital,
- the growing importance of tax-exempt institutional investors as providers of such capital, and
- the difficulty for residence countries in taxing effectively the return on international debt capital,

lead most source countries to exempt the return on such capital. Source countries allow domestic enterprises to deduct the costs of such capital incurred to unrelated third parties and forgo a withholding tax on interest payments. Once invested in the equity of a local enterprise, however, international investment capital can less easily flee the source country's tax system. In addition, most countries seek to tax the return on equity to some extent.

The third basis for source country taxation is where local production offers a better return than can be earned elsewhere. Thus, a tax based on the

value added by local production or on the economic rents of domestic enterprises should not normally discourage inward investment.

The ACE Corporation Tax in an International Setting

The difficulties posed by different tax systems are at least mitigated if countries do not depart from those elements of taxation as are subject to broad international agreement. In this respect, the ACE corporation tax remains a profits-based tax that does not differ significantly from existing corporation tax systems – such as dividend exemption, dividend deduction and split-rate systems.

It does, however, divide the corporate tax base between two competing taxing jurisdictions – the ordinary return on the investment capital is treated as belonging to the residence country and balance of the profits is taxed by the source country. The ACE corporation tax, being based on a company's economic rents, provides a sound basis for international taxation. By treating debt and equity finance in similar fashion, the ACE corporation tax also helps redress the international bias towards debt and against equity capital.

Inward Investment to the UK

Extending the ACE Allowance to Foreign Shareholders

Under present UK rules, foreign shareholders suffer corporation tax on the profits attributable to their interest in the company. They may only recover a part of that tax if they qualify for repayment of the tax credit under a treaty.

The ACE allowance extends an *automatic* relief from corporation tax to foreign shareholders. Those shareholders still suffer tax on any profits above the ACE allowance. But the UK gives up tax on the ACE allowance without regard to any treaty. Its only recourse against foreign shareholders for tax on the earnings represented by the ACE allowance is to recover tax by withholding it from dividends paid abroad.

Dividends Paid within the European Union

The UK is, however, prevented under measures adopted by the European Union from imposing a withholding tax on dividends paid by a UK subsidiary to its parent company within the Union. This does not prevent the use of a withholding tax where dividends are paid to foreign portfolio investors or

on dividends paid outside the Member States of the Union. Specific measures, similar to those adopted in some other Member States, could be used to prevent third country investors from routing their investments through other Member States to avoid the UK withholding tax.

The UK would be giving up some tax revenue that it currently collects from foreign shareholders. The position for dividends would be similar to that on interest, where the UK makes provision for a withholding tax but normally forgoes the tax on internationally provided debt. On the other hand, the UK would save tax on the economic rents earned on inward investment for which it currently gives a tax credit. With a 15 per cent return on capital, a 5 per cent ACE rate and an unchanged corporation tax rate, the effective rate of taxation on foreign shareholders declines from around 28 per cent under the current system to about 22 per cent under the ACE corporation tax.

Treaty Relief

The abolition of the tax credit on dividends makes redundant any existing treaty provision for the repayment of the tax credit to foreign shareholders. However, as the figures in the previous paragraph illustrate, such shareholders are not prejudiced because they receive the equivalent of a tax credit through the ACE allowance. Under the ACE corporation tax, the UK would be taxing company profits less heavily than most of its treaty partners do in their own jurisdiction.

Only if the UK corporation tax rate is increased, or the profits earned on inward investment are significantly greater than the ACE allowance, is the UK tax burden on foreign shareholders likely to increase. Even if that is the case, however, the ACE corporation tax still only taxes the economic rents attributable to the company's activities within the UK.

Furthermore, if shareholders' funds include sums lent by a controlling shareholder, with interest passing through the SFA as a non-deductible item, there would be no incentive for a foreign direct investor to reduce equity capital in preference to debt to obtain a deduction for the cost of capital.

Where a withholding tax can be imposed, the rate would be governed by existing treaty arrangements. The overall position of foreign shareholders necessarily depends not only upon their UK tax position but upon the way in which their home country taxes any UK profits and dividends.

Branch Taxation

Specific provision is required to extend the ACE corporation tax to UK branches of foreign investors, in much the same way as the system is extended to unincorporated businesses (see p. 43 above).

Foreign Direct Investment by UK Companies

There are two basic approaches to foreign direct investment:

- where credit is given against the domestic tax liability for taxes on profits earned abroad – the "credit system", and
- where foreign profits are exempt at home, provided they have been earned in a country which taxes profits – the "exemption system".

The ACE corporation tax can operate on either basis but we favour the exemption system. Investment in and returns earned through foreign companies are then treated in the same way as domestic investment and returns. Dividends and capital gains pass through the SFA as described on p.33. If the exemption system is adopted, specific provision is needed to ensure that shareholders' funds exclude amounts employed as foreign branch capital.

The ACE Corporation Tax in a European Context

The Ruding Committee Criteria

The UK can adopt the ACE corporation tax unilaterally if it wishes. The international aspects of the tax do not require multilateral action, although they may result in some sacrifice of UK tax in favour of foreign shareholders or their governments.

However, the adoption of the ACE corporation tax on a multilateral basis within the European Union would satisfy the criteria identified by the Ruding Committee for a European corporation tax – namely, that it should achieve neutrality between:

- different legal structures,
- different methods of financing,
- distributed and undistributed profits, and
- investment in the equity of domestic and other Member State companies.

The equal treatment that the ACE concept achieves for incorporated and unincorporated business profits meets the Commission's proposal that unincorporated businesses be free to elect to be taxed as companies.

The ACE corporation tax also could create the conditions needed to establish a strong European equity market, the importance of which was identified by the Ruding Committee, and for fair distribution of tax revenues between source and residence states.

Elimination of Distortions Within the Single Market

The ACE corporation tax, implemented on a European-wide basis, would largely eliminate distortions between the different corporate tax systems, without the need to harmonise the tax base. It would be unnecessary to implement many of the detailed measures proposed by the Ruding Committee for approximating the tax bases of the different corporate tax systems. It should reduce the cost of capital for enterprises across the Member States and allow us to meet the Ruding Committee's recommendation that taxation liabilities be based on the company's reported accounting profits. The ACE corporation tax would nevertheless remain sensitive to the tax rate adopted in each country.

The absence of withholding taxes on dividends paid between parent and subsidiary companies within the European Union, and the proposed removal of withholding taxes on interest and royalties paid between such companies, would be consistent with a European ACE corporation tax. Subject to treaty provisions, a European-wide withholding tax could be implemented for dividends paid by European Union companies to shareholders in non-European Union countries.

CHAPTER 9
GIFTS AND INHERITANCE

Inheritance Tax

Inheritance tax is unaffected by our proposals. Gifts of EXPEP and non-EXPEP savings continue to be subject to inheritance tax if made within seven years of death. Equally, all assets, whether within an EXPEP or not, remain subject to tax on death. Inheritance tax reform is not central to our proposals for taxing savings and profits. Any decision to continue, to abolish or to modify the existing tax can be independent of those proposals.

Nevertheless, inheritance tax raises very little revenue. It is difficult to state a coherent or rational purpose for the tax in its present form. Indeed, the present taxation of gifts and inheritance – a combination of inheritance and capital gains tax – lacks a rational basis and can barely be described as fair.

The direction of the tax system, irrespective of our proposals, is towards the exemption of the return on savings. Leaving pension entitlements out of account, wealth, and therefore investment income and gains, are concentrated in the hands of a relatively small section of the population. Under those circumstances, the effective taxation of gifts and inheritance goes some way towards improving the overall fairness of the tax system. However, if tax is to be charged on capital transfers, in our view an accessions tax represents the best option – i.e. a combined gifts and inheritance tax charged on the donee or heir rather than the donor or the deceased's estate. Amounts that have borne such tax might then be allowed to enter an EXPEP account.

Capital Gains Tax on Gifts and Death

Assets Held Within an EXPEP Account

Assets held within an EXPEP account are exempt from capital gains tax whether they are given away during the individual's lifetime or pass on death. The donee or heir acquires them at their current market value but is not entitled automatically to continue the EXPEP treatment of those assets. EXPEP accounts accordingly provide some incentive to distribute assets among a number of donees or heirs to allow them to be transferred back into

a tax-free environment more quickly. There is a case, however, for allowing EXPEP treatment to continue where the assets are given by a husband to his wife, or vice versa, or pass between them on the death of one of them.

Assets Held Outside an EXPEP Account

Capital gains tax on a gift of assets that are held outside an EXPEP account is unaffected by our proposals. At present, tax is charged on the gift of some assets but can be held over on the gift of others. The scope of this hold-over relief could be reviewed in the light of the other changes to capital gains tax that we have suggested.

Unrealised capital gains on assets held at death have not been taxed since 1971. Exemption on death provides a major incentive to defer realising gains. Giving up outstanding income tax liabilities on a person's death would not normally be tolerated. There therefore seems little reason to forgive the tax on any capital gains that have accrued on non-EXPEP assets.

In this respect, inheritance tax is no substitute for capital gains tax. The inheritance tax falls upon the capital value of an estate irrespective of any capital gains accrued on the assets within the estate. And the estate may be exempt from inheritance tax even though the main component of its value is gains on the estate's assets.

We believe that the capital gains tax charge ought, ideally, to be reintroduced on death. One option would be to limit that charge to gains accruing after the date of its reintroduction. It would in any event be limited to those assets that remained outside EXPEP accounts.

A charge on assets held outside EXPEP accounts might also be considered on emigration. So far as the tax man is concerned, emigration is equivalent to death.

CHAPTER 10
IMPLEMENTING EXPEPS AND ACE

EXPEP Accounts

As an extension of existing savings plans, we do not anticipate particular difficulties in introducing EXPEP accounts. Our proposal for *unlimited* saving in EXPEP accounts out of taxed income (see p. 21) and for reinvestment relief (see p. 42) each has precedents on which we can draw. The proposal for unlimited saving in EXPEP accounts allows the existing stock of savings to be transferred into EXPEP accounts at a manageable rate.

The ACE Corporation Tax

Shareholders' Funds of Existing Companies

We presented our outline of the ACE corporation tax in Chapter 6 in terms of a company established after the introduction of the tax. If there were no transitional measures for existing companies, their dividends would cease to carry a tax credit but such companies would initially have a negligible ACE allowance. The tax would at the outset have similar consequences for such companies as merely exempting dividends from tax (see p. 13).

Potentially, existing equity capital is placed at a disadvantage to new capital that counts as part of shareholders' funds. There would be a considerable incentive for companies affected in this way to enter into arrangements designed to replace their existing capital with new capital. We prefer, therefore, to allow existing companies to calculate an opening balance for their Shareholders' Funds Account on the introduction of the tax. This would be based upon existing information regarding share capital, undistributed reserves and asset costs.

The Distribution of the Corporate Tax Burden

The introduction of the ACE corporation tax with an unchanged corporate tax rate on an unchanged tax base would reduce the corporate tax burden for all companies. The option is always available not to increase the corporate

tax rate and to recoup tax revenues from other measures. However, if the corporate tax rate were increased, as it was when the current corporation tax was introduced in 1973, the corporate tax burden would shift among existing companies from those earning a return at or below the ACE rate to those earning higher profits.

As an effect of the tax this is no more objectionable than deciding to tax individuals with large earnings at a higher rate than those with low earnings. If, however, it were thought unacceptable or unsatisfactory to achieve this result in one step, it would be possible to phase in for existing companies both any increase in tax rate and the ACE allowance.

The Impact on Existing Savings

The ACE corporation tax, by exempting from corporation tax profits up to the ACE allowance, confers a potential benefit on the owners of existing capital. To take a simple illustration, individuals who hold medium-term government gilts which pay interest close to the ACE rate, presently pay tax on the interest as it arises. With the ACE corporation tax in place, those individuals can defer tax on the interest by investing in such securities indirectly through a company rather than directly. The interest is then taxed only as and when the company distributes it to them or they sell their shares. This is the same result as we noted on p. 41 in relation to the taxation of the proprietors of unquoted companies.

Although tax can be deferred in this way, it is balanced by the proposal we made on p. 21 for unlimited saving in EXPEP accounts out of taxed income. Individuals can defer tax but only at the expense of reducing the amount that they can save for the future in an EXPEP account. In addition, the savings that would benefit from this deferral are unlikely to be large relative to aggregate savings. The benefit of deferral to an individual should also not be overstated. Over 10 years £100 invested at the ACE rate of 7 per cent produces £158.03 after income tax at 40 per cent on withdrawal in the final year. This compares with an out-turn for an individual of £150.90 on a £100 deposit over 10 years at present. Nevertheless, the benefit to particular individuals may still be thought to be too great and one that we might wish to avoid.

Transitional Measures

The best transitional measure for the ACE corporation tax is undoubtedly the maintenance over time of Personal Equity Plans, or the introduction of EXPEP accounts. Nevertheless, if we still wish to reduce the benefits to the remaining taxable stock of savings of a move to the ACE corporation tax, there are a number of measures that we can consider. They include:

- the apportionment of income and gains received or realised by an investment company;
- limiting the ACE allowance to shareholders' funds employed for active business purposes rather than portfolio investment purposes;
- a compensatory tax on a company's ACE allowance that could be credited against income tax deducted from dividends;
- a modified imputation system with the ACT set-off and tax credit being limited to the ACE allowance; and
- the gradual introduction of the ACE allowance, balanced by the gradual withdrawal of the existing tax credit on dividends.

We examine these in our final Report. However, we do not favour the re-introduction of apportionment and each of the other options necessarily detracts from the benefits that the ACE corporation tax can offer. We prefer, therefore, to adopt the ACE corporation tax without such measures and accept whatever advantage it may confer on some. The overall benefit of the tax in our view outweighs any individual advantage that may accrue. Nevertheless, these measures offer options for a transition to the tax, if one is required.

The Revenue Costs

EXPEP Accounts

Our proposals do not go so far as to exempt all savings immediately, or even in the longer term. Not only is their impact phased in over time, but as existing schemes continue, their cost reduces. We are set on this course and our proposals are merely an incremental development.

The cost of EXPEP accounts largely comprises the tax forgone on the future returns on EXPEP savings. If the fixed annual contribution limit for

EXPEPs were initially to be the aggregate of the existing limits for PEPs and TESSAs, there should be no additional cost implied in the proposal. However, we anticipate that EXPEP accounts will be more popular still than PEPs and TESSAs, principally because lower income groups are better able to take advantage of the proposals by holding existing bank and building society deposits in an EXPEP account. Tax on bank and building society interest amounted to £4.25bn in 1992–93 but this is expected to fall as the full impact of lower interest rates feeds through to revenues.

The future cost would also be increased by our proposal for saving unlimited amounts in an EXPEP account. However, a portion of savings remains taxable. In addition, we need to take account of any revenue gains from other measures that we might take as consistent with the introduction of EXPEP accounts and the ACE corporation tax (see p. 58). Overall, we estimate that the net cost of these proposals after taking account of those other measures would be no more than £3.5bn. Such a cost is entirely manageable as part of the annual Budget judgement.

The Corporation Tax Rate

The ACE allowance is similar to an individual's personal allowance. It represents a first slice of profits that any company can earn before it starts to pay tax. For the reasons given on p. 41, we envisage that the small companies' rate of corporation tax would disappear. However, even allowing for this, if existing as well as new companies receive a full ACE allowance for their shareholders' funds, the tax rate must rise if we wish to maintain existing corporate tax revenues. As explained on p. 41, a logical tax rate for the ACE corporation tax is 40 per cent, equal to the highest rate of income tax. At this rate employees' earnings, the self-employed's profits and company profits bear tax at the same rate (ignoring the questions that National Insurance contributions raise).

Such a rate is still within the range of corporation tax rates imposed by other major industrialised countries. While companies would pay corporation tax at a higher rate, the tax is paid only on profits after deduction of the ACE allowance. As an immediate measure, however, the burden of the corporation tax is shifted from companies earning profits at or below their ACE allowance to those earning profits above their allowance. In the short term, therefore, the corporate tax rate and any cost of introducing the tax depend crucially on the form of the transitional package adopted.

Other Measures

We have formulated our proposals as the major elements of a strategy towards the taxation of savings and profits that can be adopted over time. We envisage that, in doing so, a number of other changes that are consistent with our eventual objective would be considered. A number of these have already been mentioned. They include:

- the phasing-out of interest relief – including MIRAS – for individuals, other than interest paid on business loans;
- the reduction of the annual capital gains tax exemption. This would be an easier administrative option with the abolition of capital gains tax indexation, the increased savings in tax-exempt form and the introduction of self-assessment;
- the phasing-out of capital gains tax on retirement relief;
- the introduction of a charge on unrealised capital gains on assets held on death; and
- the continued capping of contributions to pension funds and to personal pension plans.

The adoption of some or all of these measures reduces the revenue costs of our main proposals. Some of these measures were among those listed on pp. 11–12 that we rejected as not being a satisfactory way forward. However, the substantial majority of savings comprised in EXPEP accounts are unaffected by such measures.

CHAPTER 11
CONCLUSION

Savings

The Deficiencies of the Current System

In Chapter 2 we set down three main criteria for designing satisfactory measures to tax savings: neutrality, fairness and transparency. Taken overall, the present regime for taxing savings satisfies none of these. A substantial part of the revenue currently raised by taxing investment income and gains comes from taxing interest earned on bank or building society accounts. The taxation of such interest is certainly "transparent". But by failing to adjust for inflation, such taxation lacks neutrality. The resulting overtaxation of interest, in comparison with the taxation or exemption of other forms of savings, lacks fairness.

Similar criticisms can be levelled at other elements of the system. Capital gains tax is immensely complicated. It works only on the basis that the majority of gains are exempt from tax. The accrued income scheme quite correctly seeks to tax accrued interest on a sale of securities. But the scheme is difficult to understand and administer and it takes no account of any gain or loss that arises from inflation or from fluctuations in market interest rates.

The criticism extends to institutional investment. The taxation of savings in the form of life assurance products must represent the least transparent area of savings taxation. The emphasis on saving for retirement ties up large sums in long-term institutional form and distorts life-time patterns of saving and consumption. The favourable treatment of owner-occupied housing has created a preoccupation with investment in the scarcest of commodities on a small island, rather than with investment in productive assets.

The Scope for Reform

Compared with the total stock of savings in the economy, the UK raises little revenue from taxing savings. The revenue it does raise is reduced by the cost of the tax subsidies that are available for certain forms of savings, notably

through mortgage interest relief and the tax-free lump sum under approved pension schemes.

The tax system takes the taxation of savings as its starting point, but then forgoes tax on savings through a series of special reliefs and exemptions. In doing so, it distorts savings and investment decisions across the economy as a whole and unduly penalises the less well-off and the un- or ill-advised.

It is easy to criticise the existing system. Each of the assorted measures to relieve savings from taxation was no doubt introduced with the best of motives. Once in place, however, such measures are difficult to remove. Any tax incentive quickly acquires a vocal constituency for its preservation. That apart, however, such measures reflect two enduring features of savings taxation: the inherent administrative difficulty of taxing savings satisfactorily, and the instinctive desire to encourage savings and investment in the economy by relieving it from tax.

The nature, extent and variety of special measures outlined on pp. 16–19, but more particularly the various reforms that we outlined on pp. 11–12, illustrate the difficulty of reversing the current direction of the tax system.

Our final judgement is that the more profitable direction for reform lies in the extension of Personal Equity Plans to all forms of financial asset. The economic gains from greater freedom in saving decisions – *setting savings free* – justify whatever advantages may accrue to particular individuals from exempting a larger part of their investment income and gains through EXPEP accounts. Indeed, over time the taxation of savings should be more neutral, fairer and more transparent. Lower income groups benefit from our proposals. Furthermore we believe that the concept of exemption for savings from taxed sources is readily understood and commands support.

Profits

This approach to savings offers the opportunity to rationalise the treatment of existing savings and to reform the taxation of savings held outside our proposed EXPEP accounts. The scope for further reforms depends, however, in part upon changes in the taxation of profits.

The current system of corporation tax is based on the premise that most shareholders pay tax at the lower or basic rate of income tax. Is the current corporation tax system sustainable in the long run if the majority of corporate equity is held in tax-exempt form? We do not think that it is.

We think that the reform of profits taxation could follow three broad directions:

- taxing corporate profits as we do at present but exempting dividends and giving no credit for the corporation tax paid by the company (see p. 13);
- taxing corporate profits as at present but with no deduction for financing costs, so as to equalise the treatment of debt and equity; or
- taxing a company's economic rents through the ACE corporation tax.

The ACE corporation tax, by exempting the ordinary return on corporate investment, is consistent with the exemption of savings. It does not, however, prevent us taxing the shareholder on that return, if we wish to, as and when it is withdrawn or realised without reinvestment. The benefit of the ACE concept is that it provides a proper measure of profit that can then be taxed without distorting to any significant extent investment decisions or decisions as to the way in which investments are financed. Internationally, and particularly within Europe, it provides a satisfactory system if more widely adopted.

Institutional Savings and Investment

The adoption of EXPEP accounts over time secures far greater uniformity in the institutional savings market. The ACE corporation tax consolidates this rationalisation of institutional savings and investment. The tax exempts both inter-company dividends and capital gains realised on inter-company shareholdings. Most institutional investment accordingly becomes exempt with tax being charged (if at all) on the saver on the withdrawal or realisation of accumulated savings from the investment plan.

Implementation

In Chapter 2 we posed two questions for any reforms – whether they improved the system and whether they could be achieved. Our proposals for savings represent an incremental development of the existing UK tax system. While the ACE concept appears novel, it is a natural development of integrated personal and corporate tax systems, in particular as a larger part of personal savings becomes exempt from tax.

Our proposals would improve the taxation of savings and profits in the UK. As an incremental development of the existing system our proposals can be achieved. They offer the opportunity for the simplification of the tax system. Given existing proposals for self-assessment for companies and individuals, that is a desirable objective in itself, quite apart from the wider benefits to be had from our proposals.