HM TREASURY

HM Revenue & Customs

Impact Assessments

March 2010

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Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury/ HM Revenue and Customs	**Impact Assessment of Changes to the Tax-based Venture Capital Schemes and Enterprise Management Incentives**	
Stage: Final	**Version:** 1	**Date:** 24 March 2010
Related Publications:		

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What is the problem under consideration? Why is government intervention necessary?

This impact assessment covers legislative changes announced at PBR 2009 and proposed in Finance Bill 2010 for the Venture Capital Schemes - the Enterprise Investment Scheme (EIS), Venture Capital Trusts (VCTs) and Enterprise Management Incentives (EMI). The venture capital schemes give tax relief to investors in small companies that otherwise have difficulty raising finance. EMI gives tax advantages to some employee share options, to help smaller companies, particularly in the riskier areas of the economy, recruit and retain the staff they need to grow. The changes are needed to ensure the schemes comply with the European State Aid Risk Capital guidelines and EU fundamental treaty freedoms while remaining effective and attractive means of levering risk capital. into small

What are the policy objectives and the intended effects?

State aid approval was received for the schemes in 2009. The objective is to meet commitments given to the European Commission, as a basis for the approval, that they would comply with the Risk Capital Guidelines and the fundamental freedoms. Complying will secure the future of the schemes and ensure they remain an effective means of promoting business growth and enterprise among small higher risk trading companies. This is especially important given the current challenging economic conditions which are making access to finance problems more acute.

What policy options have been considered? Please justify any preferred option.

Option 1: Ensuring compliance with the state aid guidelines by: (a) making the venture capital schemes and EMI more flexible by relaxing the limitations on where target companies can carry on their activities and where VCTs can be listed; (b) excluding enterprises in difficulty from the venture capital schemes and (c) changing the minimum equity requirements for VCTs.

Option 2: Doing nothing. Failure to take action could ultimately result in state aid approval for the schemes being withdrawn. Operation of the schemes would then be suspended.

Option 1 is preferred as the best way of meeting the policy objectives.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Impacts will be assessed on an ongoing basis. Any significant impact on VCT fundraising will be seen by 2011. EIS will take several years because of the long time lags for company returns as will EMI, due to time lags between grant and exercise of share options.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs'.

Signed by the responsible Minister:

Date: 19 March 2010

Summary: Analysis & Evidence

Policy Option: 1	Description: Amend the schemes to improve flexibility and achieve compliance with state aid rules

COSTS

ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'
One-off (Transition)	Yrs	Relaxing territorial restrictions should see more companies and individuals using the schemes and incurring average annual costs in providing information. VCTs will incur one-off costs from adapting investment strategies to the need to hold a greater share of new qualifying investments in eligible shares.
£ 200,000-300,000		
Average Annual Cost (excluding one-off)		
£ 100,000-120,000		Total Cost (PV) £ see evidence base

Other key non-monetised costs by 'main affected groups' Allowing VCTs to list on any European Union Regulated Market is not expected to significantly increase compliance costs. Overall, the net increase in the value of tax relief claims is forecast to be around £20m in 2011-12, £30m in 2012-13, and £40m per annum thereafter.

BENEFITS

ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'
One-off	Yrs	There may be a reduction in VCT fundraising due to the change to the minimum equity requirement. If this occurs, it will marginally reduce the volume of information VCTs and their investors need to pass to HMRC each year.
£ 0		
Average Annual Benefit (excluding one-off)		
£ 35,000-45,000		Total Benefit (PV) £ see evidence base

Other key non-monetised benefits by 'main affected groups' Companies gain improved access to finance. Investors gain additional tax relief of around £20m in 2011-12, £30m in 2012-13, and £40m per year therafter by making higher risk investments than they might otherwise have done. Average investment returns are particularly uncertain and are therefore not monetised.

Key Assumptions/Sensitivities/Risks The extent to which increased flexibility will lead to a net increase in investment is uncertain, as is the ability of VCTs to adapt to being required to hold a greater proportion of qualifying holdings in eligible shares for new investments. It is assumed that there are no cost implications from relaxing the territorial rule for EMI and excluding companies in difficulty.

Price Base Year 2009	Time Period Years p.a	Net Benefit Range (NPV) £ See evidence base	NET BENEFIT (NPV Best estimate) £ See evidence base

What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	2010			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ 0			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ 0			
What is the value of changes in greenhouse gas emissions?	£ 0			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro As small	Small <£750	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)
Increase of £ 50,000		Decrease of £ 5,000	Net Impact	£ 45,000 increase

Key: Annual costs and benefits: (Net) Present

Evidence Base (for summary sheets)

THE ISSUE

The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are tax-based venture capital schemes. They aim to improve small higher risk trading companies' ability to secure longer-term financial support in the form of equity investments.[1] They do this by offering investors income, capital gains and corporation tax reliefs in return for investing in small companies undertaking an activity (trade) that qualifies under either scheme.

Enterprise Management Incentives (EMI) are tax advantaged employee share schemes, under which companies can offer their employees share options with income tax and National Insurance contribution advantages. EMI is designed to help smaller companies, particularly in the riskier areas of the economy, to recruit and retain the staff they need to grow.

The EIS has raised almost £6.3 billion, which has been invested in around 14,500 small companies. VCTs have raised £3.5 billion and invested in over 1,500 small companies.

Access to finance is currently a particular concern to many businesses: the availability of capital is limited and banks have changed their approach to risk, tightening lending conditions. It is therefore important to ensure the venture capital schemes remain an effective and attractive means of levering risk capital into small companies, which now face further difficulties in securing appropriate levels of finance than previously.

The schemes were notified to the European Commission as state aids in May 2007. They received approval in 2009, subject to a number of changes being made at the first opportunity to ensure that the rules governing the schemes comply with the State Aid Risk Capital guidelines and the EU fundamental treaty freedoms. Failure to comply could jeopardise the approval, leading to the schemes having to be suspended. This would have a negative impact on the supply of risk capital flowing to small companies.

(Please see http://www.berr.gov.uk/files/file39836.pdf for answers to frequently asked questions on state aid. For the State Aid Risk Capital guidelines, published in 2006, please see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF).

POLICY OBJECTIVES AND INTENDED EFFECTS

The main policy objective is to ensure the venture capital schemes remain an effective and attractive means of incentivising investments in smaller companies that might otherwise struggle to raise appropriate levels of finance and that EMI continues to be effective. This is particularly important given the current challenging economic conditions. The Government intends to achieve this by securing state aid approval for the schemes.

This will secure the future of the schemes, ensuring that they play as active a role as possible in supporting small companies during the downturn. This is also important to ensure the stability of the EIS and VCT sectors, allowing them to plan for the future and continue to play a role in the economic recovery.

Changes to secure this approval will involve relaxing the limitations on where the trade is carried on. This presents the additional benefit of increasing the number of small companies eligible for investments under the schemes. Some companies which may previously have been ineligible as a result of their international activity may now be able to qualify for investments. It

[1] The schemes' rules outline what is meant by a small higher risk trading company in this impact assessment. Small companies are defined as having gross assets not exceeding £7 million before the share issue and £8 million after; employment must be less than 50 full-time equivalent employees when shares are issued. There are also rules to ensure companies are independent and trading. Certain activities are excluded from the schemes in order to target higher risk trades more in need of support. (For details, please see: http://www.hmrc.gov.uk/manuals/vcmmanual/index.htm).

will also allow companies, already benefiting from investments under the schemes, to take greater advantage of the international opportunities to expand.

In the same vein, the Government also intends to allow VCTs to list elsewhere in Europe, should that make most commercial sense.

OPTIONS

Option 1 Amend the schemes' rules:

(a) Relax the rule requiring investee companies' activities to be carried on "wholly or mainly" in the UK (common to both schemes and EMI) and the requirement for VCTs to be UK-listed;

(b) Exclude "Enterprises in Difficulty" from the venture capital schemes; and

(c) Change the minimum equity requirements for VCTs.

Option 2 Do nothing

The Government prefers option 1 because it is expected to deliver the policy objectives, whereas option 2 clearly would not.

Option1: Amend the Scheme Rules

(a) Relax the rule requiring investee companies' activities to be carried on "wholly or mainly" in the UK (common to both schemes and EMI), and the requirement for VCTs to be UK-listed.

- Companies qualifying to receive investments under the schemes are currently required to carry out their qualifying activities "wholly or mainly" in the UK as are companies benefiting from EMI. HMRC interpret the requirement as meaning that more than 50 per cent of the qualifying activities should be in the UK.
- The Government now intends to relax this rule to simply require any company receiving investments under the tax-based venture capital schemes to have a permanent establishment in the UK. The definition used will be based upon that contained in Article 5 of the OECD Model Tax Convention on Income and on Capital (2003).
- There is also currently a requirement for VCTs that "the shares making up the company's ordinary share capital...have been or will be included in the official UK list throughout the relevant period".
- The Government now proposes to relax this rule. Instead, the shares making up the company's ordinary share capital will be required to be admitted to trading on a European Union Regulated Market. A "European Union Regulated Market" is any regulated market named under the Markets in Financial Instruments Directive (MiFID).

This option is preferred as it also responds to calls from small business and the venture capital sector to make the schemes more flexible. It will also play a part in the broader efforts to improve access to finance, as more UK companies would qualify for investments under the schemes. This will stimulate investment activity by providing more investment opportunities for individuals and facilitating cross-border activity.

The Government therefore intends to introduce legislative changes in Finance Bill 2010 to give effect to these relaxations.

(b) Exclude "Enterprises in Difficulty" from the venture capital schemes

- There is currently no exclusion of enterprises "in difficulty" from benefiting from either of the schemes

- The Government now proposes to introduce a rule excluding companies that are “in difficulty” according to the criteria set out in the Commission’s guidelines on State aid for rescue and restructuring from the benefit of the venture capital schemes

This option gives a simple test, based on the Commission’s own guidance. The Government considers it unlikely that companies genuinely in difficulty according to these criteria would be able to raise equity funding.

(c) Change the minimum equity requirements for VCTs

VCTs are currently obliged to onward invest a minimum of 70 per cent of their total fund in ‘qualifying holdings’. Of that 70 per cent, a minimum of 30 per cent (i.e. 21 per cent of the total fund) must be in ‘eligible shares’, which the Commission accepts constitutes ‘equity’ according to the definitions in the State Aid Risk Capital guidelines. However, these guidelines require that 70 per cent of qualifying holdings be invested in ‘equity’ or ‘quasi-equity’.

The Government therefore intends to introduce legislation in Finance Bill 2010 to require that a minimum of 70 per cent VCTs’ qualifying holdings (i.e. 49 per cent of the total fund) must be in a form that the Commission would accept as ‘equity’ <u>or</u> ‘quasi-equity’. The Government does not propose to use the term ‘quasi equity’ but legislation will define the sorts of instrument that will count towards the new requirement.

This option is preferred as the Government is legally obliged to ensure the rules governing the VCT scheme comply with the State Aid Risk Capital guidelines. Failure to do so would result in state aid approval for the scheme being withheld and the suspension of the schemes.

Option 2: Do Nothing

Failure to implement these changes could result in the European Commission revoking state aid approval and operation of the schemes being suspended. The UK Government would probably at this stage be forced to abolish the schemes. This impact assessment considers only the cost of the schemes having to be closed to new investments. However, the European Commission could in principle also potentially require the UK Government to reclaim some relief already given under the schemes. This would apply to relief given directly to investors, which the small companies benefited from indirectly.

CONSULTATION

The Government published draft legislation at PBR and consulted stakeholders on its detail. Stakeholders were generally content with the suggested approach. The legislation to be proposed in Finance Bill 2010 takes account of a number of points of detail, in particular by relaxing the rule that determines when a VCT “controls” a company in which it requests, reflecting the changes described at (c) above.

COSTS & BENEFITS

The compliance costs and benefits of the policy options are estimated based on the expected impact on normally efficient and compliant businesses and individuals. Compliance costs are likely to consist of either:

- the average time taken by individuals, small companies, and VCTs to complete tasks themselves charged at an average wage rate; or
- the average increases in professional fees where tasks are likely to be undertaken by an agent.

The wage rate used is £12.50. This is based on the 2008 average gross hourly rate for clerks and bookkeepers, uplifted for overheads (taken from the Annual Survey of Hours and Earnings).

Option 1: One-Off Costs

Businesses

Some small companies and VCTs seeking investment as well as professional advisers will be directly affected by the relaxation of the "wholly or mainly" in the UK rule. They will incur learning costs in understanding the impact of the new rule and the new opportunities it may present. As a proxy for this we assume that each company/VCT raising funds in the first year incurs an average cost of £50 each in time and/or a marginal increase in professional fees. The total cost of this is estimated at around £100,000.

We do not expect established VCTs to move to another European Union Regulated Market because of the costs of moving relative to any benefits. Estimated cost is negligible.

Increasing the minimum equity requirement for all new VCT investments should only result in significant one-off costs for VCTs raising funds. The cost per VCT of learning of the change is assumed to cost an average of £50. Implementing the change will be more costly because many VCTs looking to raise funds will have to amend their investment strategy for new investment in terms of how they structure their qualifying holdings in small companies. The information received by HMRC on the composition of VCT qualifying holdings has only partial coverage, but suggests that some trusts already appear to exceed 70 per cent equity. These are mainly AIM quoted plus some specialist VCTs. Meanwhile, those closer to the current 30 per cent rule appear to be mainly generalist VCTs. Without scope for consultation on the likely implementation costs, we assume that the one-off costs of implementation in terms of time and other costs will on average be around £5,000 per VCT raising funds. We assume this applies to around three-quarters of those raising funds. These costs are in addition to any learning costs. There have been around 40 VCTs per year raising funds on average while income tax relief has been at 30 per cent (see http://www.hmrc.gov.uk/stats/venture/table8.6.pdf). Total cost is estimated at around £150,000.

Individuals

We expect the one-off costs for individuals to be negligible from the relaxation of the "wholly or mainly" in the UK rule because they are only indirectly affected by what amounts to the reworking of an existing rule. There will be more companies that can use EIS and more companies for VCTs to invest in. However, the learning and search costs per individual are unlikely to be significantly different for investors who would have invested through the schemes anyhow. Evidence that only a minority of investors keep abreast of changes to the scheme rules once they have invested would tend to support this (see http://www.hmrc.gov.uk/research/report.pdf).

We expect the one-off costs for individuals to be negligible from changing the minimum equity requirement for VCTs because they are only indirectly affected by what amounts to the reworking of an existing rule. Therefore, learning costs per investor are unlikely to change significantly as a result.

Option 1: Average Annual Costs

Businesses

Relaxation of the "wholly or mainly" in the UK rule should result in more small companies raising equity through the schemes. This will result in a flow of additional information having to be provided to HMRC each year by the additional companies and the VCTs in respect of these extra investments. Providing such information constitutes an average annual cost. Based on existing estimates for the administrative burden of the schemes, we calculate the costs to be around £55,000. This is based on additional activity equivalent to around 10-15 per cent more companies and VCTs raising funds through the schemes. Although this cannot be reliably forecast, it would imply around 250 more EIS companies and around 5 more VCTs than would otherwise have been the case. (For overall activity in the schemes, see http://www.hmrc.gov.uk/stats/pensions/index.htm).

The change to the minimum equity requirement is a change to an existing rule, and so should not generate significant additional burdens in providing information to HMRC. Any new VCTs entering the market would have to apply one threshold rather than another. Therefore, the average annual costs to VCTs are estimated to be nil or negligible.

Individuals

Consistent with the increase in the number of companies raising equity through the schemes, we also expect additional investors. Although it is difficult to predict with any accuracy, we assume the policy change will attract around 2,000 additional EIS investors and around 2,500 more in VCTs (i.e. an increase of around 15 per cent). These taxpayers will need to provide information to HMRC in order to obtain their tax relief. These additional claims and additional people learning about the schemes each year form an average annual cost. Income tax claims are typically relatively simple and straightforward. They are claimed either via Self Assessment, a scheme specific form or a PAYE coding notice. We therefore assume the cost to be an average of £12.50 per additional claim to proxy for the individual's time or a marginal increase in professional fees for those represented by an agent. Claims will predominantly be from higher rate taxpayers and often those already on SA with relatively complex tax affairs. The total cost is estimated at around £55,000.

For changing the minimum equity requirement for VCTs, we expect the average annual costs for individuals to be negligible. This is because they are only indirectly affected by what amounts to the reworking of an existing rule. The tasks undertaken to make an investment and claim relief would remain the same.

Option 1: Benefits

There are no one-off benefits anticipated. The average annual benefits of improving the flexibility of the schemes are potentially:

- Businesses – More companies will be able to attract risk capital using the schemes and those with a significant share of their trade carried out overseas will no longer see their potential limited in scope by a "wholly or mainly" in the UK rule. The ability of the schemes to address the 'equity gap' encountered by small, higher risk trading companies will therefore be improved. Empirical evidence suggests that the schemes may have a positive effect on the investment levels of EIS/VCT companies (see http://www.hmrc.gov.uk/research/report44.pdf).
- Individuals – Investors will be able to obtain tax relief on a wider range of risk capital investments through the schemes, which may lead to better post-tax rates of return on capital that may have been invested elsewhere.

The only anticipated on-going benefits to business and individuals from changing the minimum equity requirement for VCTs are from compliance cost savings due to a reduction in VCT fundraising:

- Businesses: Although it is speculative, we have estimated that there will be around 5 fewer VCTs raising funds each year, which will reduce the cost of providing information to HMRC by around £5,000 per annum.
- Individuals: We have assumed a similar proportionate reduction for individuals claiming tax relief each year, reducing the need to provide information to HMRC by around £35,000 per annum.

The above benefits do not include the forecast value of additional tax relief claims. This is because in cost-benefit analysis terms tax relief represents a transfer payment from one group in society to another rather than a net increase in the welfare of society as a whole. Instead, any positive impact on output in the economy due to the additional tax relief or any reductions in compliance costs count as benefits. The cost of tax relief is incurred from 2011-12 rather than 2010-11 due to the time lags involved in administering the reliefs.

The difficulty here is that while we can make reasonable estimates of compliance cost savings, any positive impact on the economy of more investment through the schemes cannot be reliably measured. This is because the schemes are just one factor affecting small company performance relative to the alternative investment choices that could have been made instead (i.e. in the absence of the venture capital reliefs). The economic impact of more investment through the schemes is not quantified as a monetised benefit and is instead described qualitatively in the non-monetised box on page 2. Research evidence points towards the tax relief being the primary attraction of investments through the schemes in many cases (see http://www.hmrc.gov.uk/research/report.pdf and http://www.hmrc.gov.uk/research/cgt-final-report26.pdf). However, given the risky nature of the investments, many are loss-making in pre-tax terms.

The table below summarises the above monetised costs and benefits. Estimates have not been produced on a net present value basis both because the schemes have no end date and because the main benefits of option 1 could not readily be monetised.

Option 1: Monetised Costs and Benefits			
Impact:	**Impact on:**	**Estimate:**	**Published Range:**
One-Off Cost	**Businesses**	£250,000	-
	Individuals	£0	-
	TOTAL	**£250,000**	**£200,000-£300,000**
Average Annual Cost	**Businesses**	£55,000	-
	Individuals	£55,000	-
	TOTAL	**£110,000**	**£100,000-120,000**
One-Off Benefit	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Benefit	**Businesses**	£5,000	-
	Individuals	£35,000	-
	TOTAL	**£40,000**	**£35,000-45,000**

Option 2: Do Nothing

As already outlined, this option would lead to the suspension of the schemes. Investors would lose tax relief and small, higher risk trading companies would find it more difficult to secure the funds they need to invest and grow.

One-Off Costs

It is likely that most VCTs would incur the one-off costs of running down in the years after the scheme closes to new investment. The majority are unlikely to be sustainable without tax relief. Such costs cannot be readily quantified and are thus non-monetised in our estimates.

Average Annual Costs

As discussed under the benefits of option 1, any investment returns accruing to investors and other shareholders cannot be readily estimated and generalised. With option 2, therefore, the cost of suspension in these terms is likewise difficult to quantify.

One-Off Benefits

There would be no one-off benefits of suspension.

Average Annual Benefits

Suspending the schemes would mean that small companies, VCTs and their investors would no longer incur the average annual costs of providing information to HMRC each year. Based on current populations of companies, VCTs and investors using the schemes each year and the same assumptions used for option 1, the average annual cost savings of suspending the schemes would be around £700,000.

Although it has not been possible to quantify all of the cost and benefits, the benefits in terms of the additional investment returns generated by the schemes are still likely to outweigh the compliance cost savings of suspension. For example, in 2006-07 total funds raised through the venture capital schemes were almost £1billion versus compliance costs per year of less than £1million. Therefore, the schemes would only have to generate additional pre-tax investment returns of around 0.1 per cent for the benefits to businesses and individuals from retaining them to exceed the costs each year.

The table below summarises the above monetised costs and benefits. Estimates have not been produced on a net present value basis both because the schemes have no end date and because the main costs of option 2 could not readily be monetised.

Option 2: Monetised Costs and Benefits			
Impact:	**Impact on:**	**Estimate:**	**Published Range:**
One-Off Cost	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Cost	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
One-Off Benefit	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Benefit	**Businesses**	£400,000	-
	Individuals	£300,000	-
	TOTAL	**£700,000**	**£600,000-800,000**

ADMINISTRATIVE BURDEN

HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular; the admin burden of disclosing information to HMRC or to third parties. This burden is assessed through the 'Standard Cost Model' (SCM), an activity based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.[2]

[2] The 'Standard Cost Model' (SCM) has been used to derive an estimate of the costs to business of complying with HMRC obligations to disclose information to HMRC or to third parties. The SCM considers which activities a business has to do to comply with an HMRC obligation, how many businesses have to comply, and how often they need to comply. The SCM considers the burdens applying to different sizes of business.

Central estimates of admin burdens are £50,000 per annum for part (a) of option 1, £0 for part (b) and -£5,000 per annum for part (c). These are burdens incurred by companies and VCTs. Burdens borne directly by individuals who are a separate legal entity to the business, such as directors, employees and shareholders, are not included under the SCM. A 2005 wage rate of £11.70 is assumed for in-house tasks. As described under average annual costs, part (a) of option 1 should result in additional burdens due to more activity through the schemes, whereas part (c) should result in a reduction in VCT fundraising.

On the same basis, the administrative burden savings from option 2 is estimated at around £385,000 per annum.

Assumptions & Risks

With option 1, the main risk is that the measure has less of a positive overall impact on small companies' ability to raise risk capital. The negative effect on VCTs could be greater, whereas the increase in funds raised because of increased flexibility could be less than assumed here. The extent of the impact of the changes is difficult to predict in advance. The timing of the tax effects is on a National Accounts basis.

Equity and fairness

These changes will affect small companies (with fewer than 50 employees and gross assets of less than £7 million before investment) that receive, or may seek to receive investments under the EIS and VCT schemes. Individuals who make investments in these small companies, either through the EIS or through a VCT, will also be affected as will the VCT and EIS Fund industries. These changes should not disproportionately affect any other sectors.

Implementation plan, monitoring and evaluation

The changes will be legislated in 2010. Draft legislation and guidance will be published on the HMRC website. Implementation of the policy will not require additional resources for HMRC. National Statistics on the schemes are published annually on the HMRC website and the impact of these changes should be reflected in this monitoring data. Statistics on VCT fundraising are currently published within 6 months of the end of the tax year. EIS statistics take three years to compile due to the time companies have to file those returns. Further evaluation studies may be commissioned to assess the overall impact of the schemes in addition to those already published by HMRC.

Small Firms Impact Test

These options affect only small companies (with a headcount of fewer than 50 employees and gross assets of less than £7 million before investment) that receive or may seek to receive equity investments benefiting from tax relief under the tax-based venture capital schemes.

With option 1, the relaxation of the "wholly or mainly" test described should benefit small companies receiving investments under the venture capital schemes, by improving their ability to take advantage of opportunities to expand internationally. Changing the VCT minimum equity

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The SCM estimates the costs of using agents; the costs of undertaking work in-house; and the costs of actually transmitting the information. The SCM does not consider one-off costs or transitional costs. The SCM does not consider costs which a business would have incurred anyway had the relevant HMRC obligation not existed. It considers the costs which apply to a normally efficient business and the costs to businesses which comply. The SCM does not consider wider compliance cost issues, such as the costs of business uncertainty, cash flow costs, or the costs of deciding whether or not to do something.

The Impact Assessment template requires SCM figures to be presented in May 2005 prices, as admin burden reduction targets relate to a May 2005 baseline. The Impact Assessment also uplifts those figures to current day prices.

requirement should have no direct impact on small companies, as they apply to requirements governing VCTs.

Under option 2, small companies would be harmed by the reduction in the availability of equity finance that would ensue from the suspension of tax relief offered by the schemes.

It was not possible to carry out a consultation among small companies on the effect of these changes prior to their announcement. This was due to the confidential nature of negotiations between the UK Government and the European Commission, and due to market sensitivities.

Competition Impact Test

The proposed changes are not expected to have any adverse impacts on competition. Neither option should:

- directly limit the number or range of suppliers;
- indirectly limit the number or range of suppliers;
- limit the ability of suppliers to compete; nor
- reduce suppliers' incentives to compete vigorously.

Under option 1, the changes are required to ensure compatibility with state aid guidelines. State aid control is intended to ensure that Government interventions do not distort competition or intra-community trade. The tax-based venture capital schemes are interventions intended to correct for 'equity gap' market failures whereby small companies in qualifying trades can struggle to raise appropriate finance compared to larger businesses or lower risk trades. They should have a positive effect on competition in markets by supporting new entrants.

Relaxing the territorial requirements of the schemes should have a positive effect on the competition process by opening the schemes up to more business opportunities that may face an 'equity gap'. Raising the minimum equity requirement for VCTs (from 30 per cent to 70 per cent) should also aid the competition process by reducing any distortions caused by the scheme; it should better focussing VCT portfolios on those companies most likely to be both eligible for the schemes and facing an equity gap. Even if some VCTs that already meet the 70 per cent requirement gain a head start or some exit the market, competition between VCTs is unlikely to be significantly diminished. This is because the change is not expected to significantly raise barriers to entry, meaning that the threat of new VCTs entering the market will remain a constraint on the behaviour of incumbents.

Under option 2, suspension of the schemes would remove any competitive distortions caused by the schemes favouring small companies in qualifying trades over other businesses, large and small. However, it would exacerbate the 'equity gap' in the UK, making it harder to raise the equity needed for small companies to enter markets, compete and grow.

Other Impact Tests

Competition assessment

We have applied the Office of Fair Trading competition filter to these changes and concluded they have no impact on competition

Small Firms Impact test

The changes ensure that the Venture Capital Schemes – which support small companies in raising finance – will continue to be available. After consultation the sector, based on draft legislation, the original proposals have been modified to take account of view received

Legal aid

There will be no need for new criminal sanctions or civil penalties

Sustainable development

The changes will be in accordance with the principles of sustainable development

Race equality, disability equality, gender equality and human rights

An initial equality impact assessment has confirmed that the changes have no negative impacts

Rural issues

The changes will not have a significantly different effect in rural areas. Neither will they significantly impact carbon emissions, other environment or health.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	**Title:**	
HMRC	**Impact Assessment of Excise: Modernisation and Compliance Checks**	
Stage: Final	**Version:** 3.0	**Date:** 8th March 2010

Related Publications: **Consultation Documents** – Modernising Powers, Deterrents and Safeguards: Excise: Modernisation and Compliance Checks – 9th July 2009 and 9th December 2009

Available to view or download at:

http://www.hmrc.gov.uk/consultations

Contact for enquiries: Laura Lucking **Telephone: 078255 46464**

What is the problem under consideration? Why is government intervention necessary?

Excise legislation has evolved over many years, resulting in different systems and procedures applying to different regimes. These differences impact particularly on those involved in the production, holding and movement of alcohols, tobacco and oils. While there are good reasons for this in some cases, in others it has led to duplication of information and unnecessary administrative complexity.
After the Commissioners of Revenue and Customs Act 2005 created HMRC from the two former Departments a project was set up to review the powers, safeguards and deterrents available across the different tax and duty regimes, introducing alignment where appropriate and ensuring they are fit for modern purposes. Excise forms the final tranche of this work on compliance checking powers.

What are the policy objectives and the intended effects?

Following the 2008 Finance Act (FA 2008) and with extension in the 2009 Finance Act (FA 2009), HMRC have aligned record-keeping rules, information and inspection powers and assessment and claim time limits across the majority of taxes and duties for which they have responsibility. Excise duties have been the main exception. The focus of the excise review was to ensure that HMRC has powers that are modern and can be used effectively to tackle large scale excise frauds, met the needs of changing operational focus and retain sufficient safeguards for legitimate traders and businesses. It was also important to look at aligning any areas with changes made in the FA 2008 and 2009, where appropriate.

What policy options have been considered? Please justify any preferred option. 1. Do nothing

2. Modernise the excise administrative provisions (this is now being progressed over a longer period and therefore is not covered in this Impact Assessment, estimated benefits are in version 2.0 9/12/2009)

3. Modernise the excise compliance checking powers, including alignment of record-keeping rules and time limits for assessing additional duty due or making claims for duty relief.

Option 3 is preferred, with Option 2 following over a longer period to allow requirements, costs and benefits to be more fully explored. Improved compliance checking powers will help HMRC deal more effectively with those operating illicitly while limiting the impact on the legitimate trade.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post implementation review will take place between 1 – 3 years after the full implementation of any option.

Ministerial Sign-off For final Impact Assessment:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Date: 19 March 2010

Sarah McCarthy-Fry

Summary: Analysis & Evidence

Policy Option: 3	Modernise the excise compliance checking powers

COSTS

ANNUAL COSTS		
One-off (Transition)	**Yrs**	
£ Negligible		
Average Annual Cost (excluding one-off)		
£ Not Applicable		

Description and scale of **key monetised costs** by 'main affected groups'. HMRC costs will be on staff training, which should be minimal as these are relatively small changes to existing legislation. If appropriate HMRC will share training material with traders, whose only costs in relation to the changes will be to update their knowledge.

Total Cost (PV) **£ Negligible**

Other **key non-monetised costs** by 'main affected groups' As with any change in policy there would be an initial familiarisation process with the changes to the powers, however it is expected this will be minimal for taxpayers. The key change would be in relation to the new information power and taxpayers may need to understand that process for making representations.

BENEFITS

ANNUAL BENEFITS		
One-off	**Yrs**	
£ Negligible		
Average Annual Benefit (excluding one-off)		
£ Negligible		

Description and scale of **key monetised benefits** by 'main affected groups' Uniformity across recording-keeping principles would assist taxpayers in understanding their obligations, reducing instances of mistake. Aligned time-limits will make it easier for traders to know what is expected and when. There may be a negligible increase in the level of yield recovered from assessments that can cover 4, rather than 3, years.

Total Benefit (PV) **£ Negligible**

Other **key non-monetised benefits** by 'main affected groups' Taxpayers would benefit from aligned record-keeping principles and time limits across the taxes and duties. Enhanced HMRC powers to tackle illegitimate trading, used in conjunction with operational strategies to address the non-compliant should benefit legitimate businesses who face unfair competition from illicit trade.

Key Assumptions/Sensitivities/Risks While this option should help to reduce taxpayers' compliance costs through aligned time limits and make HMRC more efficient in carrying out its responsibilities, HMRC does not have the evidence base to provide accurate figures for the overall benefits or impacts of these changes.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) **£ Not quantifiable**	**NET BENEFIT** (NPV Best estimate) **£ Not quantifiable**

What is the geographic coverage of the policy/option?			United Kingdom	
On what date will the policy be implemented?			01/04/11	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Negligible	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro £0	Small £0	Medium £0	Large £0
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ **Negligible** Decrease of £ **Negligible** **Net Impact** £ **Negligible**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Introduction

HMRC has approximately 11,000 customers across the different excise regimes, ranging from large to small businesses. Taxpayers within these regimes bring in over £45 billion per year, the vast majority from a small number of big players. This represents 10 per cent of the total amount of revenue collected by HMRC each year.

This revenue is generated within the following excise regimes which are examined in this consultation:

- goods for consumption: alcohol (beer, wine, made-wine, cider, perry and spirits), tobacco and energy products, including the holding and movement of such goods in duty suspension;
- gambling: profits based (general betting duty, bingo duty, pool betting duty, gaming duty and remote gaming duty); and by ticket sales (lottery duty);
- air passenger duty (APD) charged on chargeable passengers in chargeable aircraft; and
- Amusement Machine Licensing Duty (AMLD)[1].

The current tax gap figures for the excise regimes state that the exchequer is losing between £1.9 billion and £4.7 billion in unpaid duty every year[2] –

> Tobacco (cigarettes and hand rolling tobacco): £1bn - £2.65bn
> Alcohol (spirits only): £150m - £350m
> Oils (petrol and diesel in Great Britain and Northern Ireland): £790m - £1.740bn.

In the period since 2005 HMRC has seized nearly 15 million litres of alcohol with a taxable dutiable value of over £33 million, issued demands for more than £178 million of evaded duty and prosecuted 15 major criminal gangs who were involved in alcohol fraud.[3]

For oils[4] in the period since 2005, 4 million litres of diesel has been confiscated, 84 fuel laundering plants have been disrupted and 45 criminal convictions have been successfully obtained.

For tobacco, in the period since 2000 HMRC has seized over 14 billion cigarettes and more than 1000 tonnes of hand rolling tobacco in the UK and abroad. It has broken up over 370 criminal gangs, successfully prosecuted over 2,000 people and issued over £35 million worth of Confiscation Orders[5].

HMRC needs effective powers to be able to counter this level of threat.

Excise legislation focuses on those classified as Revenue Traders (s1(1) Customs and Excise Management Act 1979 - CEMA). This term is wide ranging and includes any person carrying on a trade or business subject to any of the revenue trade provisions of the customs and excise Acts and those who 'buy, sell, import, export, deal in or handle' any goods liable to excise duty[6].

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[1] The Government issued a consultation on the future of gaming machine taxation on 16 July 2009. The deadline for responses was 23 October 2009. The Government is analysing the responses received to the consultation, and will give full consideration to the industry's views before any decisions are taken.
In addition to the consultation on gaming machines, the Government will continue to engage with the gaming machine industry about the general state of the sector and the impact of taxation.

[2] From 'Measuring Tax Gaps 2009', HMRC, December 2009, www.hmrc.gov.uk/stats/measuring-tax-gaps.pdf

[3] Figures from the "Renewal of the Tackling Alcohol Fraud" Strategy published by HMRC and UKBA at Budget 2009 http://www.hmrc.gov.uk/budget2009/tackling-alcohol-2850.pdf

[4] HMRC Autumn Performance Report 2008 p.53 http://www.hmrc.gov.uk/about/autumn-report-2008.pdf

[5] Figures from "Tackling Tobacco Smuggling Together" published by HM Revenue and Customs and the UK Border Agency in November 2008 http://www.hmrc.gov.uk/pbr2008/tobacco-2800.pdf

[6] Annex A in the first Impact Assessment includes a more detailed list of excise sectors covered by this consultation, and a list of the most common types of revenue trader. Annex B in the first Impact Assessment provides indicative figures of the numbers involved in and the amounts generated by the main excise regimes.

Policy objectives and intended effects

When the Commissioners of Revenue and Customs Act 2005 created HMRC it left in place all the legislation that governed the different tax and duty regimes. This meant that there were different powers and obligations for the different taxes. The Review of Powers, Deterrents and Safeguards was introduced to address this issue, looking across the regimes to ensure the powers and safeguards were suitable for the modern climate, and introducing alignment where appropriate.

As a result of this work legislation was passed in the Finance Acts 2008 and 2009 providing aligned powers for all HMRC taxes and duties in relation to time limits, record-keeping requirements and information and inspection powers. However the significant differences in the excise regimes, where the focus is on goods rather than records, resulted in excise being reviewed separately.

The main focus of excise powers is to enable HMRC officers to check that goods held or moved in duty suspension do not enter the market without duty being paid, and to enable officers to check the quality of excisable goods coming into the UK market (e.g. whether the diesel being sold through petrol stations is safe). Therefore to complete the work of the Review of Powers it was necessary for HMRC to look at whether the legislation and powers governing the excise regimes provided the powers needed to tackle the current risks, whilst also giving the safeguards needed in modern times.

During the first consultation HMRC took the opportunity to look at possible ways to modernise the administrative processes of the excise framework. Excise administrative requirements have grown up over a long period, and often in a piecemeal fashion, and therefore can be complex and difficult to manage. HMRC was looking for ways to simplify the processes and procedures involved for taxpayers engaging in the regime.

The responses to the proposed changes were broadly positive but stakeholders made it clear that the modernisation should be solidly based with computerised solutions. In light of this, the modernisation work is being taken forward over a longer time scale to allow HMRC to build a better picture of what an IT system would need to deliver and the costs and benefits involved for both the Department and the trade.

As part of a wider project the compliance powers for customs duties and international trade are being reviewed over the next few years. The changes made to excise as a result of this work will be taken into account as the customs work moves forward.

Policy Development Process

First Consultation (July – October 2009)

The consultation process started with the publication of the Excise: Modernisation and Compliance Checks consultation document, and the first impact assessment, on 9th July 2009. That process lasted 12 weeks until 1st October 2009.

The consultation document sought views on the full range of proposals relating to both modernisation of excise administration and the review of the compliance checking powers.

The responses are detailed in the 'Excise: Modernisation and Compliance Checks; the next stage' document and impact assessment that were published on 9th December 2009[7].

The consultation sought views from a broad cross section of external stakeholders, both through representative bodies and through direct contact with key businesses, as well as from a wide range of internal stakeholders involved in operating the excise regimes. Information was also gathered from HMRC analysts and through interrogation of internal HMRC systems.

[7] Documents can be found at http://www.hmrc.gov.uk/pbr2009/supplementary.htm#ia

HMRC conducted nine one to one external meetings; attended three meetings hosted by representative bodies to discuss the proposals and received fourteen written responses.

Responses to the first consultation were in general positive, both in relation to the modernisation proposals and the compliance checks changes. The first consultation successfully gained responses from across the different excise sectors and they helped refine the proposals.

Second Consultation (December 2009 – March 2010)

The second consultation was published on 9th December 2009, again providing a 12 week period for responses. With modernisation proposals being taken forward over a different time frame this iteration focused on the detail of proposed changes to the compliance powers within CEMA, with draft clauses published on 14th January 2010.

HMRC received written responses from across the regimes and held meetings which were attended by a variety of external stakeholders to discuss the details of the proposed legislation, as well as attending various other Fora. The key comments are outlined below. HMRC also held meetings with internal stakeholders with views sought from across the Department.

Responses were generally positive, recognising that HMRC is attempting to ensure it has all the tools necessary to tackle the illicit trade, whilst ensuring there is adequate and useful protection for legitimate businesses.

Option 3 – Modernise the excise compliance checking powers, including record-keeping requirements and time limits for assessing additional duty due or making claims for duty relief (Recommended)

The way in which HMRC checks that the right tax has been paid across the majority of HMRC taxes and duties is broadly similar. But there are key differences in the types of check required for goods based excise duty regimes and those required for other HMRC taxes and duties where the focus is much more on paper audit. Within excise goods based regimes the risk lies predominantly with the goods themselves, including their holding and movement in duty suspense, where the high margins provide an incentive for people to involve themselves in the illicit market for those goods.

Proposals Consulted on:

The second consultation provided detailed proposals on the following areas:

1. an aligned high-level record-keeping rules;
2. aligning time limits for claims and assessments to 4 years, retaining the 20 year extension for certain cases;
3. inspection powers amended in sections 112 and 118 CEMA to allow inspection of documents, and in section 161A to allow the search for documents under a warrant;
4. explicit prohibition of entry to premises used solely as a dwelling;
5. a new power that would enable HMRC to impose a penalty when an officer encounters obstruction on an unannounced visit. To use this penalty the visit would need to be pre-authorised by the tribunal; and
6. a new information power that would allow HMRC to seek information from other parties such as banks. Safeguards would be a formal notice requirement and new right of appeal.

It also sought views on proposals to improve the way HMRC shares information with external licensing authorities regarding excise wrongdoing by those with licences, and on whether there was any merit in looking to utilise VAT anti-fraud techniques in the excise arena.

Responses to the Second Consultation - Compliance Checks

1. Record Keeping – stakeholders generally felt the alignment was sensible, although there was some concern that it was not used to change the type of documents required to be retained which it was felt should always be related to business documents.

HMRC can reassure respondents that there are no plans to change the regime specific requirements in relation to records.

2. Time Limits – no issues were raised with the principle and it was generally considered that alignment with the other taxes was sensible. There were questions regarding whether transitional arrangements would be used.

HMRC can confirm that there are plans to use transitional arrangements, and that they are likely to be based on those used for the VAT changes,

3. Inspection Powers – stakeholders were generally supportive of the changes proposed. The focus on ensuring HMRC were able to access documents in relation to goods was welcomed, as was making it explicit that officers cannot enter solely domestic dwellings, although there were questions raised regarding the objectivity that would be applied to the concept of 'solely'. There was support for HMRC using its powers robustly to target illicit trade, and a recognition that there should be detailed guidance for officers on how and when to use the various powers.

When the changes proposed are implemented HMRC will review the guidance available for officers and will ensure that it provides clear guidance on the changes and how the powers should be used, specifically in relation to domestic dwellings.

4. Information Powers – there was support for HMRC's need to be able to access information to determine the provenance of goods. The need for tribunal approval to request information from a non-revenue trader was welcomed, but it was raised that the non-revenue traders should be able to appeal against supplying it, especially if there is a cost involved.

HMRC can confirm that those who are asked for information under an information notice will be given opportunity to provide representations if they do not think they should be required to. These representations will be supplied to the tribunal (possibly in summary form) as part of the application for the information notice.

5. Penalty for obstruction – There were no strong views either way in response to this idea. Although some stakeholders could see a theoretical use in having it they could not see that it would add practical value. There was particular concern that it would actually be used against the wrong people i.e. those left in charge of premises but who are not in control of the stock etc. There were also suggestions that to be effective the penalty would have to be so high that it would become disproportionate.

HMRC will not be taking forward this aspect of the proposals as a result of the various issues raised during consultation.

6. Information sharing – it was proposed that HMRC should be making better use of information that it holds on excise wrongdoing by those licensed to operate in the excise arena, e.g. retail sellers of alcohol, hauliers. There was mixed response to the concept. Although most saw some value in it, as an additional tool to restrict the amount of illicit market available, there were strong suggestions that various safeguards be put in place to ensure it could not be used against innocent parties.

HMRC can give reassurance that the information sharing proposal will have a range of safeguards built into the framework. The initial test for passing information will be three seizures from the same premises/person. Each of these seizures has an appeal right and a decision as to whether information will be passed will not be made until the opportunity for appeal has passed. A single HMRC team will have the responsibility for leading this work.

7. VAT anti-fraud concepts – HMRC also asked for views on the practicalities of using VAT anti-fraud concepts in relation to excise. Particularly whether there would be benefit in using a joint and several liability approach where a purchaser 'knew or should have known' that duty had not been paid on the goods they were buying, Although stakeholders welcomed HMRC looking for innovative ways to tackle the illicit trade there were concerns that the VAT approach had a disproportionate impact on legitimate trade and that it would not easily fit with transferral to the excise arena because of the significant differences in the way the duty is administered, However the work did highlight that some of the issues currently causing difficulty in this area may be addressed with the transposition of the EC Directive 118/08/EC in new Holding and Movements regulations. These regulations become effective from the 1st April 2010 and HMRC will monitor the impact that these regulations have, particularly in relation to this issue.

Again due to issues raised as part of the consultation this proposal is not being taken forward.

In light of these comments, and discussions with internal stakeholders, the penalty proposals and VAT fraud concepts will not be taken any further at this time. The impacts assessed below are therefore only in relation to the proposals being taken forward as part of the Finance Bill.

Full details of the responses, including issues raised that were outside the scope of the consultations, can be found in the [Excise: Modernisation and Compliance Checks: the next stage, Consultation Response Document, March 2010].

Current Proposals

It was recognised throughout both consultations that HMRC needs distinct powers for excise, in order to operate the regime effectively and to successfully protect the public, the exchequer and the legitimate trade from the risks associated with illicit and counterfeit product. Whilst aligning record-keeping and time limits was seen as sensible, it was agreed early on that it was not appropriate to align excise information and inspection powers to the compliance checking framework introduced for the other taxes in FA 2008 and 2009. Different powers are needed when the risk is associated with goods and therefore the proposals have focused on making small amendments to the current legislation to ensure that the powers provide what is needed.

The legitimate trade recognised that HMRC need robust powers, acknowledging that safeguards would be in how those powers are applied. They were mainly focused on wanting HMRC to use its powers to their full force to tackle the illicit trade that can undermine their businesses.

Therefore the measure put forward is made up of the following components:

Align Record-keeping rules

The proposal is to align excise with the FA 2008 rules about record-keeping.

This will allow taxpayers to retain information rather than the original records themselves, unless conditions or exceptions are specified in writing by HMRC. Although it is not quantifiable, this should reduce the administrative burden on taxpayers who will be able to store all their records in the form most suitable to their business, with the same overarching principle governing record-keeping for all taxes and duties. It also represents a minor simplification by expressing the requirement in the same way across all taxes and duties.

There are no proposals to change the record keeping requirements specific to individual excise regimes, or the period for which records should be retained.

Align Assessment and claim time limits

The proposal is to bring excise time limits into line with time limits for the other taxes and duties, following the FA 2008 and 2009 changes. This means extending the three year limit for claims and assessments to four years. The 20 year extension will be retained but the behaviours that trigger its use will be aligned so that there is consistency. However the 20 year extension will not be triggered for a failure to notify unless it is deliberate, which is slightly different to other taxes.

Amend Information and inspection powers

Most people in the UK want to pay the tax and duty they owe; however for the minority their determination not to pay what is due is part of a wider failure to comply with the law. This is particularly true in relation to excise duties, where those who smuggle alcohol and tobacco may be linked to counterfeit products and the funding of organised crime. Therefore HMRC needs a framework for checking compliance that is strong enough to tackle illicit trade, and is an effective tool in protecting the public, the trade and the exchequer.

It is because of the additional risk that is inherent in goods based excise regimes that it is proposed that the framework set out in Schedule 36 will not be sufficient.

The first consultation highlighted the need to strengthen HMRC’s ability to request the records necessary to establish the provenance of the goods. Therefore the amendments made to the CEMA powers largely focus on access to information.

The measure would now introduce the following amendments to the CEMA powers:

- to allow inspection of documents when entering premises of a revenue trader, or suspected revenue trader, under section 112 or section 118 CEMA;

- a legislative prohibition on entry to solely domestic dwellings (within both s112 and s118)’

- an amendment of section 161A CEMA to allow the search warrant to be used to search for documents relating to goods liable to excise duty; and

- to clarify the existing entry powers to include premises owned by others who are storing excise goods but who may argue that they are not revenue traders.

The proposals also introduce a new information power that is based in powers introduced by Schedule 36 for other taxes:

- The power would allow HMRC to ask for information from a wider range of institutions and individuals than is currently the case. The information must pertain to excise matters and the protection of the revenue, but using this powers it could be requested from for example a bank. The power has an inbuilt safeguard to ensure that it is used proportionately and appropriately, as this information can only be requested by a notice that has been approved by the tribunal.

Passing details of infringements to other UK regulatory authorities

HMRC is continuing to look at establishing a more consistent and regular approach to passing information about excise wrongdoing to the relevant UK regulatory authorities, so that this information can be used to inform their assessment of an individual's fitness to hold such a licence and prompt a review of the licence.

This would not require further legislation as HMRC is entitled to disclose information for the purpose of achieving its functions (under section 18(2) Commissioners of Revenue and Customs Act). HMRC has continued to work with the Home Office and other interested parties (particularly the Traffic Commissioners and Vehicle and Operator Services Agency) to establish the details and structure of a protocol.

The current suggestion is that HMRC would pass to external licensing authorities’ information where there have been 3 or more failures to comply with the excise regimes (or where a substantial assessment is raised). The independent licensing authority would then be able to decide whether it was relevant to the criteria for retaining that licence. This would act as a deterrent to businesses who currently risk having goods seized due to the high returns but are less likely to risk losing a licence that is crucial to their business. It would also work for the benefit of legitimate traders who may see licences removed or amended for those businesses who are not acting legitimately, and therefore are able to undercut prices.

HMRC would in no way seek to influence how the information was used, as a key safeguard is the independence of the licensing authority.

This work will continue, and although a legislative change is not required, the benefits of the change are included below as this could have an important impact on HMRC's work to tackle those repeatedly found to be engaged in excise wrongdoing.

Implementation

A discrete team within the Compliance area will lead on the implementation of the changes to CEMA, as part of their work on New Ways of Working. Although the changes to excise are different and less substantial, the experience they have of implementing the changes to compliance checks (main and other taxes) legislated in FA 2008 and 2009 will be invaluable. As part of this role they will be working to update guidance and develop training material which, as previously, they aim to share with key stakeholders.

The work of the team will be overseen by a Project Board which has experience of working on the implementation of previous changes.

Further details on the costs are detailed below.

New proposals: Impact

Revenue

There may be an impact on revenue from changes to time limits, as it will allow taxpayers to make a claim for repayment and HMRC to assess for duty for an additional year.

The level of repayments within excise varies from regime to regime. Approximately £160m is repaid, in total, every year. The majority of this amount is made up of drawback[8] claims from hydrocarbon oils and alcohol (£81 million and £24 million respectively). These drawback claims are sent in quarterly as soon after the relevant event as possible. Therefore the extension to 4 years is likely to have a very limited impact on the value of claims.

As an indication of the amounts involved, in 2007-08 for excise duties there were £170 million in net additional revenue from duty assessments and error corrections by taxpayers.

To try to determine what the overall impact of this change will be on revenue a sampling exercise has being carried out by HMRC's operational areas. This looked at the number of assessments that were affected by the current 3 year cap as a proportion of assessments raised by those areas. It was not possible to carry out a representative sample because of the time it would have taken. So the number of cases that were reviewed across the different areas means that these figures are merely indicative.

The results show that the number of cases per year currently impacted by the 3 year cap is very small. It is assumed that the number of cases using the extension to 4 years would be the same percentage as those currently using the full 3 years, and that the same amount will be assessed for the fourth year as the third year. The result would be an increase in the value of assessments by up to £2 million per annum[9]. This is a negligible increase in revenue and supports the anecdotal view given in consultation

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[8] Drawback allows for the repayment of excise duty paid on goods that have not been and will not be consumed in the UK.

[9] This is an upper estimate.

meetings, where experience (rather than data) suggested that there would be a minimal impact on traders since it was very rare for circumstances to arise where there would be need to go back 3 years for either a claim or an assessment.

Costs

Implementation

There may be one-off ‘implementation’ costs for some taxpayers and agents as they learn about the changes. The cost is likely to be limited as the proposed changes are relatively minor and amend existing legislation rather than replacing it. The key area will be the new information power and the obligations around it. However as this is based on the powers within Schedule 36 it is expected most will be familiar with the processes. HMRC will also share its own training and guidance where appropriate.

There will be costs for HMRC in training operational and policy staff involved in excise duties, but the type and intensity of training will vary according to their roles. This will be a one-off cost as future training programmes will incorporate the changes for new staff and therefore will be part of business as usual costs.

Although more work is needed to develop the training packages and establish the precise length and nature of the training required, initial figures show between 3,000 and 3,500 staff will need training to some degree. Approximately 2,000 staff will only need a short update on the minor change to the scope of the warrant which is expected to take up to an hour (i.e. to allow search for documents as well as goods). Others will need more comprehensive training to ensure they are versed in all the changes applicable to their work and regimes. This is likely to be completed through e-learning. There may need to be some face-to-face training for up to 80 managers, and this is expected to take up to 1 day (at a cost of £150 – 175 per day per person).

The costs of training the staff and updating guidance will be small and will be absorbed as part of normal business activity.

Information Sharing

The proposals to have a more consistent process for sharing information with licensing bodies suggest using a central team to coordinate what cases are passed, so that they can take a view on the proportionality issues involved in each case and provide oversight on what information is actually sent. It is expected that this role will sit within an existing team and form part of their established business, therefore not requiring any additional funding.

Benefits

The impact on HMRC costs and yield from checking will depend on a large number of factors, including how many checks are carried out, how well they are targeted, and the extent and nature of non-compliance in the UK in future years.

Taxpayers will benefit from aligned record-keeping rules that will be consistent across the tax regimes. Whilst specific requirements will remain in place for the regimes uniform underlying rules will help taxpayers understand their obligations.

They will also benefit from a single set of time limits in respect of claims and assessments, as this will apply across their various tax obligations. Modernised criteria for engaging the 20 year extension will also link into the language used in Schedule 36 FA 2008 so that taxpayers can better understand what their rights and obligations are.

Key benefits for taxpayers in relation to the inspection and information powers will stem from knowing that the powers are fit for purpose in relation to tackling the large levels of fraud that take place in these regimes, and that HMRC is able to operate them effectively. The modernised powers will support the revised Alcohol Strategy which is changing the way that HMRC resource is used, to ensure that it is utilised to target the higher risk areas.

Legitimate businesses in the excise sector understand that the powers need to be sufficient to deal with the fraudulent end of the market, and therefore appreciate the need for specialist powers regarding entry, access and information. They also gain significant benefits from using duty suspension arrangements and so accept that in exchange for those benefits they agree to certain conditions, such as unannounced visits. Stakeholders have also repeated throughout the consultation that these powers provide an important reassurance to business that HMRC is acting to protect them by reducing the quantity of illicit product on the market. These powers will assist HMRC's operational ability to level out that playing field and reduces instances of them being undercut by illegitimate competitors.

The type of checks that can take place under the powers in relation to excise products also produces higher levels of confidence in consumers, who would be at risk from counterfeit products entering the market.

There should also be a benefit to legitimate business if work to establish an information sharing protocol with licensing authorities is completed. Although no legislative change is required HMRC has carried out some work to assess the impact of the protocol. Conducting a sample of seizures over a year (2006/7) 203 traders would have fallen within the 3 seizures rule. This is not a substantial number in terms of work load for HMRC or receiving authorities, however these traders made up 24% of total seizures. Therefore the benefit of an additional deterrent via the licensing authority is could be considerable.

Specific Impact Tests: Checklist

Full details of the specific impact tests are listed at: http://bre.berr.gov.uk/regulation/ria/toolkit/specific_impact_tests.asp. These have been applied to the options considered in this consultation.

The process of Equality Impact Assessment screening has been started and this will continue during the course of consultation and policy development.

Competition Assessment

The aim of the modernisation options considered was to make systems and procedures simpler for businesses to operate, while providing greater certainty about how HMRC views the way in which businesses manage and conduct their tax affairs.

Under the amended compliance powers, those businesses that HMRC does not view as low risk could expect to spend more time dealing with HMRC and those classified as low risk will usually spend less. But this will not impact on any business's capacity to enter markets or compete rigorously within them. These powers should help HMRC to more effectively tackle the illicit market in the excise sectors therefore improving the 'level playing field' for compliance businesses.

Applying the Office of Fair Trading's competition filter we have considered whether the proposals contained within the consultation would:

1. Directly limit the number or range of suppliers?
2. Indirectly limit the number or range of suppliers?
3. Limit the ability of suppliers to compete?
4. Reduce suppliers' incentives to compete vigorously?

1. The modernisation proposals, once fully implemented, will not impact on the number or range of suppliers as the idea behind these is to simplify the administration processes for businesses involved in excise regimes. The compliance checks will apply to all businesses, as currently, and there is no evidence that the proposals will impact on the ability of compliant businesses to trade. The revised compliance checks should help HMRC reduce the level of illicit product on the market, improving the ability of legitimate traders to compete

2. There have been no indications that the proposals will indirectly impact on the number or range of suppliers.

3. The compliance checking proposals should improve the ability of legitimate businesses to compete by making it easier for HMRC to remove illegitimate traders from the market. This will mean that legitimate businesses will not be struggling to compete with the significantly lower prices of illicit goods.

4. The proposals will in no way impact on the incentives for suppliers to compete vigorously.

These proposals will not therefore have a negative impact on competition within the excise sector. If the amended powers are taken forward they may help to improve the 'level playing field' and encourage competition by reducing the numbers of those trading in illicit goods.

Small Firms Impact Test

The modernisation proposals within this consultation are designed to reduce administrative burdens on the average compliant business. It is therefore appropriate to encompass all small firms to ensure that they can also access the cost savings. During the consultation process there have been no comments regarding disproportionate impact on small businesses.

The compliance checking proposals will generally not increase costs for compliant businesses. Views have been sought from small businesses during consultation..

Legal Aid

These proposals would not significantly increase legal aid impacts.

Sustainable Development

These proposals are in accordance with the principles of sustainable development. Simplified administrative processes, and increased ability to tackle the illicit market, supports the principles of a sustainable economy.

The government has committed to five principles of sustainable development. These are

1. Living within environmental limits;
2. Ensuring a strong, healthy and just society;
3. Achieving a sustainable economy;
4. Promoting good governance; and
5. Using sound science responsibly.

The proposals within this consultation do not impact on the first and fifth test as there is no use of science or any impact on environmental limits.

However simplification of the administration processes through modernisation and enhanced powers to assist in tackling the illicit sector of the excise market can be seen to contribute to ensuring a just society and a sustainable economy. This is particularly relevant in relation to the serious non-compliance that takes place within excise which has been used to fund organised crime. If HMRC can better tackle those involved it supports the principle of a just society. This will also help ensure that the market for excise goods becomes more legitimate and therefore promotes the sustainability of that sector.

Environmental Impact Tests

Carbon – the proposals have no significant carbon emissions impact.

Other Environmental – the proposals have no significant environmental impacts.

Health Impact

Using the Health Departments three stage screening questions it can be seen that the proposals have no significant impact on health or well-being, and therefore a complete health impact assessment does not need to be completed. However, HMRC's enhanced compliance checking powers may help to reduce risks to health by removing and preventing the sale of potentially harmful counterfeit excise goods to the public.

1. The proposals will have no direct or significant impact on health through its effects on Income, Crime, Environment, Transport, Housing, Education, Employment, Agriculture or Social cohesion. There is the possibility for a minor impact on the reduction of crime through the improved compliance checking powers but this is in relation to crimes of failing to pay duty rates and therefore any following impact on health would be minor.

2. There will be no impact on the lifestyle variables such as physical activity, diet or sexual behaviour. We can speculate that there may be an impact on alcohol use in that reducing illicit activity may push the market price up, by limiting the amount of non-duty paid product available. However that is speculative and would have a very minimal impact.

3. There will be no impact on health and social care services from these proposals.

Rural Proofing

There are no indications that these proposals will impact differently in rural areas.

Equality Impacts Tests

Equality Impacts have been considered as part of the consultation process for these proposals. This has been done in conjunction with the customer units, and reviewed with external stakeholders. It indicates that these proposals:

- will have no significant race equality impact.
- will have no significant disability equality impact.
- will have no significant gender equality impact.

The Review has undertaken Equality and Privacy Impact screening as part of developing and consulting on the proposals for this measure. No requirement for full impact assessments on these issues has been identified. The adjustments identified as part of the Review are for operational business and implementation. The Review will continue to monitor progress on these.

Human Rights

The potential impact on human rights of these proposals has been considered as part of the development of these options. The powers covered by the proposals are modernised versions of the previous CEMA powers. These powers give rise to Human Rights compatibility considerations. Our analysis is that these powers are for legitimate purposes, are lawful and proportionate, therefore justifying any interference with Human Rights. Further more the powers are supported by those who are legitimately operating in the excise arena.

The current powers were reviewed in 1998 to ensure that they were compatible with the, then new, Human Rights Act. They were held to be compliant and therefore the modernisation of those powers is also considered to be human rights compliant.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	Title:	
HM Revenue and Customs (HMRC)	**Impact Assessment of Extending Charity Tax Reliefs to Certain Organisations in Europe**	
Stage: Final Proposal	**Version:** 1.1	**Date:** 24 March 2010
Related Publications: n/a		

Available to view or download at:

http://www.hmrc.gov.uk/better-regulation/ia.htm

Contact for enquiries: HMRC Charities Policy Team **Telephone:** 020 7147 2098

What is the problem under consideration? Why is government intervention necessary?

UK charity tax reliefs have previously been restricted to UK resident charities. Following the European Court of Justice's (ECJ) judgment in the Hein Persche v Finanzamt Lüdenscheid case, the UK is required to open up charitable tax reliefs to eligible European organisations including European Community Amateur Sports Clubs (CASCs). The European Commission (EC) concluded that differential treatment across member States violates freedom of movement of capital under the EU treaty.

What are the policy objectives and the intended effects?

The Government must amend legislation to make it consistent with EU law so that eligible EU organisations (and those in Norway and Iceland) and their UK taxpayer donors may benefit from UK charitable tax reliefs. A new statutory definiton of an organisation entitled to charity tax reliefs, consistent with English law, will be introduced, which all charities and EU organisations will be required to meet in order to benefit from UK charitable tax reliefs. The legislation, as amended, will seek to limit the potential increase in fraud and abuse of these reliefs whilst mitigating the impact on existing UK charities and donors.

What policy options have been considered? Please justify any preferred option.

Option 1: Extend charitable tax reliefs to eligible EU organisations but do nothing further.

Option 2: Extend charitable tax reliefs to eligible EU organisations, introduce a stricter definition of charity in legislation whilst bringing current rules onto a statutory footing.

Option 2 is the best practicable approach to meeting the demands of the ECJ's ruling whilst minimising the risk of increased fraud. It is designed to limit the impact on existing UK charities and delivers a level playing field and greater certainty for all UK charities, eligible EU organisations and donors.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The reforms will be monitored once they are implemented. Compliance costs are routinely reviewed 1-3 years after implementation.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Date: 24 March 2010

Summary: Analysis & Evidence

Policy Option: 2	Description: Introduce an eligibility system

COSTS

ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups':
One-off (Transition)	Yrs	Annual recurring cost to UK charities providing supporting evidence on international expenditure; £100,000. Annual recurring cost to newly founded UK charities required to register with HMRC; £100,000. Costs to HMRC from all changes proposed; £2.1 million one-off and £400,000 recurring.
£ 2.1m	1	
Average Annual Cost (excluding one-off)		
£ 0.6m	10	Total Cost (PV) £ 8.1 million

Other **key non-monetised costs** by 'main affected groups': Imposing limits on the value and frequency of in-year Gift Aid repayment claims may restrict charities' cash flow. Limits will be set following consultation with the charity sector.

BENEFITS

ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups':
One-off	Yrs	
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		Total Benefit (PV) £ 0

Other **key non-monetised benefits** by 'main affected groups' There will be cost savings to HMRC if the value and frequency of in-year Gift Aid repayment claims are limited. Any resource savings will be redeployed to priorities created elsewhere by the EU changes and enable HMRC to maintain an efficient service to charities.

Key Assumptions/Sensitivities/Risks: The estimated Exchequer cost of extending reliefs to EU charities is anticipated to rise to between £150 million to £200 million by 2018-19, by which time full take-up by eligible organisations outside the UK is expected. These figures are highly sensitive to assumptions particularly over the rate of take up and the potential risks to the UK tax base from abuse and fraud.

Price Base	Time Period	Net Benefit Range (NPV)	NET BENEFIT (NPV Best estimate)
Year 2010	Years 10	£ N/A	£ -8.1 million

What is the geographic coverage of the policy/option?			EU (as extended)	
On what date will the policy be implemented?			24 March 2010	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ 400,000	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ 0	
What is the value of changes in greenhouse gas emissions?			£ 0	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	N/A	N/A	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £0 Decrease of £0 **Net Impact** £0

Key: Annual costs and benefits: Constant Prices | (Net) Present Value

Evidence Base (for summary sheets)

Background

1. The UK offers one of the most generous and comprehensive systems of tax reliefs for charities and charitable giving of all European countries. Under the current system reliefs include the following:

   - UK charities can claim repayments of tax on the gross value of cash donations under Gift Aid, equal to the basic rate of income tax;
   - UK charities can claim exemption from stamp duty land tax (SDLT) on acquisition of property;
   - UK charities can claim exemption from capital gains tax (CGT) on disposals of chargeable assets;
   - UK charities can benefit from zero or reduced rates of VAT;
   - higher rate taxpayers can claim higher-rate relief (equal to the difference between the basic rate of income tax and the higher rate) on cash donations to charities;
   - individual donors can claim income tax and CGT relief on gifts of shares and property to charity;
   - companies can claim a deduction against their gross income liable to corporation tax (CT) on donations to UK charities; and
   - gifts to UK charities can be exempt from inheritance tax (IHT).

2. Full guidance on the UK system of charitable tax reliefs can be found on the HMRC website (www.hmrc.gov.uk/charities-donors/index.htm). Table 1 below shows the Exchequer costs of charitable tax reliefs to UK charities. These figures do not include the cost of CT deductions on corporate giving, which are not separately identified, or the cost of tax exemptions on investment income of charities.

Table 1: Exchequer Costs of Charitable Reliefs (£m)

	2005-06	2006-07	2007-08	2008-09
Gift Aid repayments	£779	£859	£918	£967
National non-domestic rates	£870	£930	£960	£1,010
VAT	£200	£200	£200	£200
Stamp duty	£120	£120	£140	£200
Inheritance tax	£420	£410	£410	£290
Payroll Giving	£20	£20	£30	£30
Gifts of shares and property	£100	£60	£70	£70
Higher rate relief on Gift Aid	£190	£240	£280	£280
Total	£2,699	£2,839	£3,008	£3,047

Source: http://www.hmrc.gov.uk/stats/charities/table10-2.xls

The Issue

3. HMRC had considered that UK charitable tax reliefs (including donor reliefs) applied only to UK resident charities. In the ECJ decision in the case of Hein Persche v Finanzamt Lüdenscheid (C-318/07), it was successfully argued that differential treatment of donations across member states conflicts with the freedom of movement of capital under the EU treaty.

4. The ECJ's ruling means the UK Government must extend the current system of charitable tax reliefs to eligible European organisations and CASCs. The Government has decided that UK charitable reliefs are to be opened up to eligible organisations in the EU, together with Norway and Iceland, with whom the UK has effective information exchange agreements and tax recovery powers.

Policy Objectives

5. The purpose of the policy is to extend UK charitable tax reliefs to certain eligible EU organisations, whilst limiting Exchequer costs and the threat posed by the potential for increased fraud and abuse. With this in mind, legislation will be amended to tighten procedures to protect the Exchequer as far as possible whilst limiting any additional burden on UK charities, CASCs and non-UK organisations entitled to charity tax reliefs. The opportunity has also been taken to fix a number of known discrepancies in the rules for charitable tax reliefs.

The Options

6. Unless otherwise stated, references to "charity" below refers to UK charities and other non-UK organisations, in the EU, Norway and Iceland, entitled to UK charitable tax reliefs. This term should also be taken to include CASCs located in the UK, EU, Norway and Iceland to the extent that they are eligible for reliefs in the UK.

Option 1- Extend charitable tax reliefs to EU organisations entitled to charitable tax reliefs but do nothing further to alter UK law

7. The UK could open its charitable tax reliefs to non-UK organisations entitled to charitable tax reliefs (OECRs) without taking any action to cope with additional demand. OECRs would complete a standard application form and be required to provide the same types of supporting documentation that UK charities do at present. HMRC would need to consider whether the OECR met the normal eligibility conditions (see link for details: http://www.hmrc.gov.uk/charities/tax/recognition.htm). Such an approach would expose the Exchequer to unacceptable risk from fraudsters exploiting the UK's reliefs, in particular repayments of Gift Aid. The estimated annual cost to the Exchequer could be in the order of £500 million by 2018/19, of which approximately 90% would be attributable to fraud. These figures are highly sensitive to the fraud assumptions used. Nevertheless, there are good grounds to believe that without increased statutory authority and protection against fraudulent claims, the level of risk is considerable.

Option 2: Extend charitable tax reliefs to EU organisations entitled to charitable tax reliefs and introduce a stricter definition of charity in legislation whilst bringing current rules onto a statutory footing.

8. Under the proposed option, newly formed UK charities and OECRs seeking to benefit from any of the UK charitable tax reliefs will need to meet the new legal definition of a charity which will require them to:

   - show they satisfy the definition of a "charity" under English law or would do if they were located in England or Wales;
   - demonstrate that their trustees, directors and other managers are "fit and proper"; and
   - register with any regulators as required under the law in the country in which they are established.

9. Under the previous regime, UK charitable organisations were required to ensure that their trustees, directors and other managers were "fit & proper" persons, to the extent that they were responsible for running the organisation. The new definition of charity will place this requirement on a statutory footing. This more binding arrangement will help to ensure, as far as possible, that persons with financial responsibility for the charity are compliant and that charitable funds are not misappropriated. HMRC will apply the test flexibly taking into account the access an individual has to influence the financial affairs of the charity.

10. HMRC will dedicate increased resources to processing claims to eligibility for relief under the new regime. This resource will be used to process the increased volume of claims and contribute towards the costs of background checks into the correctness of claims. Organisations that qualify for relief will be given a reference number which will be published in a list on HMRC's website.

11. A number of smaller reforms will also be introduced to correct discrepancies with the existing rules and to streamline processing so as to provide efficiency savings. The principal changes include:

   - **Payroll Giving: -** under existing legislation, income received by a charity via Payroll Giving can be used for non-charitable purposes with no impact on tax reliefs. This is an anomaly which has been exploited by some charities. To correct the position, donations received under payroll giving will become taxable income but (as applies to Gift Aid etc) relieved from tax to the extent that they are spent for charitable purposes;

   - **limiting in-year Gift Aid repayment claims: -** there is currently no limit on the number or size of in-year Gift Aid repayments a charity or CASC can make and as a result HMRC frequently repays claims for very small amounts (a matter of a few pence). Each claim costs around £5 to process. Some charities make many claims during the year. Placing a limit on the amount of each claim and the number submitted, will reduce the volume of claims and free HMRC resources to be redeployed on the extra work created by the extension of UK charitable tax reliefs. No decision has been taken on what limits to impose. Following Budget, HMRC will consult informally with charities on the limits;

- **charities notification: -** currently charities have to apply to HMRC in order to be eligible to claim the repayment of basic rate tax on qualifying Gift Aid donations. Charities with income from other sources (such as grants or bank interest) are also strictly required to notify HMRC of chargeability. However, in most cases they are able to apply the exemption from tax on the basis that all of their income is put to charitable purposes so no tax return is needed. As a result, where a charity notifies HMRC of its existence, HMRC does not necessarily require the charity to file annual returns each year. From 1 April 2010 new charities that wish to claim a repayment of basic rate tax in respect of Gift Aid donations (or other income received under deduction of tax) will be expected to notify HMRC of their entitlement to charitable tax reliefs, by completing a new standard application form and filing a return where requested to do so. HMRC will be consulting with charities in which other circumstances charities will need to complete the application form if they do not want to make Gift Aid claims: for example, where a charity's only income is investment income which is exempt from tax. Existing UK charities that are currently not required to apply to HMRC for eligibility to claim those tax reliefs need do nothing as a result of this measure. HMRC may, in line with current practice, require existing UK charities to file a return at any time by issuing a notice to them to do so; and,

- **international expenditure: -** currently, UK charities that spend their funds abroad ("international expenditure") qualify for tax relief only if making the payment is part of the charitable objectives of the UK charity. In addition, charities are required to satisfy themselves that they have taken reasonable steps to ensure the funds are spent for charitable purposes. There is evidence that some charities have abused this provision and the new legislation will require that charities have taken reasonable steps sufficient to satisfy HMRC that the money is spent for charitable purposes. HMRC will be issuing guidance on what charities need to do to satisfy that revised test.

Costs and Benefits Compared

12. HMRC is subject to targets to reduce the administrative burden on business of disclosing information to HMRC or to third parties. This burden is assessed through the "Standard Cost Mode" (SCM). Charities were exempt from the original SCM exercise and therefore we do not cost them against this baseline.

13. The costs and benefits are only considered for UK taxpayer donors and charities. We do not consider the administrative burden or compliance cost for non-UK organisations entitled to charitable tax reliefs or non-UK CASCs. References to the impact on charities, CASCs and donors below refer to those subject to UK tax only.

Donors

14. There will be negligible costs to donors. When making charitable donations, both individual and corporate donors will need to ensure that their donation is to a genuine charity in order to qualify for tax relief (a requirement under the previous regime). To help donors, HMRC will publish a list of all eligible charities (UK charities and OECRs). This list will be available on HMRC's website. Additional space will be provided on the Self Assessment tax return to identify relief claimed for donations to non-UK OECRs.

Charities and CASCs

"Fit and Proper" Person Test

15. It is anticipated that there will be no additional cost to UK charities and CASCs on considering the "fit & proper" person test. No reputable charity would knowingly appoint persons to a position of trust who were not "fit and proper" and who were not subject to appropriate controls. Currently, UK charities are expected by various regulators to consider whether trustees, directors and financial

managers have any previous convictions for fraud or misconduct that might disqualify them from taking a post of responsibility (see the Charity Commission declaration for new trustees: www.charity-commission.gov.uk/Library/supportingcharities).

16. The new requirement reflects no fundamental change in the obligations HMRC currently expects of charities and CASCs. However, the new system places existing obligations on a clearer legislative footing. If charity trustees, say, are found to have violated this principle HMRC will need to take a view as to whether to claw back tax reliefs, where it is apparent that excessive tax relief has been given or charitable funds misappropriated. The greater the evidence of steps taken by the charity to determine that trustees are 'fit and proper', the less likely claw-back provisions will bite. This reflects no difference to the way the rules are currently applied.

Limiting In-Year Gift Aid Repayment Claims

17. Under the legislation, HMRC will limit the number and value of in-year repayment claims for Gift Aid tax relief that charities and CASCs can make. As discussed above, the cost to HMRC of processing each claim is around £5. There are a number of charities that file multiple repayment claims for very small amounts, which lead to little if any net benefit, when the cost of processing is considered. The resource spent processing such returns could be redeployed to meet other demands placed on HMRC. Any option to limit the number and value of in-year repayment claims could have a significant impact on the cash flow of a small number of charities. For this reason, HMRC will informally consult with charities following Budget 2010 to agree any options for reform.

International Expenditure

18. It is estimated that requiring charities to take reasonable steps to collect evidence to satisfy HMRC that internationally distributed funds are being spent on legitimate charitable activities will cost the UK charities sector approximately £100,000 annually. This figure is based on the following:

- there are 96,000 charities that are currently registered with HMRC;
- evidence from the Charities Aid Foundation[1] shows around 10 per cent of all UK donations goes to overseas causes;
- of these, we assume 50 per cent (based on judgement) use a charitable intermediary or recipient in that country to which funds are sent;
- figures from HMRC's Total Cost to Serve Calculator suggest it will cost each charity around £7, assuming it takes 20 minutes, to request and receive the necessary information from the subsidiary charity; and,
- we assume each charity makes four such requests per year.

19. The total net cost is calculated at: 96,000 charities x 10 per cent donations going to overseas causes x 50 per cent of charities using charitable intermediaries x 4 donations per year x £7 average cost per charity, equals £134,400. This is rounded down to £100,000.

20. It should be noted that charities will not be required to submit the evidence to satisfy HMRC that internationally distributed funds are being spent on legitimate charitable activities as a matter of course. Instead, it is to be made available if HMRC requires it. The charity must take sufficient reasonable steps to ensure that the funds distributed overseas would be applied for charitable purposes. HMRC will take account of the circumstances under which the funds were spent. Routine spending of funds should be evidence to a higher standard that, for example, spending during an international emergency.

Notification to HMRC of Tax Liabilities

21. As noted above, existing UK charities that have not approached HMRC to apply for reliefs on income such as grants or bank interest (by way of filing a return), but are applying an exemption to tax will be unaffected by this measure. If an existing UK charity that has not applied to HMRC under the previous regime becomes liable to tax and/or wants to reclaim basic rate tax on Gift Aid donations (or

[1] Individual Giving Survey (2008) http://www.cafonline.org/pdf/UK%20Giving%202008.pdf (IGS)

in respect of any other income received under deduction of UK tax) then they will be required to notify HMRC.

22. UK charities that are established after introduction of the new regime that want to claim repayment of tax in respect of Gift Aid donations (or in respect of other income received under deduction of UK tax) or have a tax liability (perhaps because they have incurred non-charitable expenditure) must notify HMRC. The individual cost to charities of applying to HMRC is likely to be small. A new application form is currently under development. It is estimated it will take approximately half an hour to complete. It is also assumed it takes charities 15 minutes to prepare and send copies of the necessary supporting documents (i.e. charity founding documents). Estimates of business time cost are taken from HMRC's Standard Cost to Serve Model, which assumes an hourly time cost to businesses of £20.40. This implies the total cost to each charity on applying to HMRC to be eligible for UK charitable tax reliefs will be £15[2].

23. The number of new charities that will need to apply to HMRC under the new regime is far harder to quantify. The National Council for Voluntary Organisations (NCVO)[3] estimate there are in the region of 300,000 charitable organisations, sports associations, education institutions and religious organisations in the UK. There are approximately 96,000 "active" charities that have applied to HMRC to claim reliefs. This leaves a maximum possible number of "general charities" that could be receiving reliefs, without notifying HMRC, of around 200,000. Further evidence from the NCVO implies the number of "general charities" has grown by 4 per cent per year, since 2001[4]. Assuming half of all these charities approach HMRC and the trend growth in "general charities" is the same for all charitable organisations, implies over the next 10 years, there will be an additional 5,000 charity registrations per-year in addition to the applications that are already received. This leads to an annual cost to the charity sector of around £100,000.

HMRC Impact

One-Off Costs

24. One-off costs to HMRC are estimated to be in the order of £2.1 million. Of this, £2 million comes from: the costs to cover IT enhancements to administer tax returns, reliefs and repayment claims from non-UK organisations and the necessary changes to donor tax returns; cater for non-UK returns and repayment claims and necessary changes to those returns; establishing the list of charities that have been found to be eligible for UK charitable tax reliefs with HMRC (to assist donors in deciding whether their donation qualifies for relief); publicising the rules around the new regime and; sending publicity material directly to charities. There will be an additional £100,000 on providing improved compliance training to staff, particularly so they are better able to identify fraudulent claims.

Annual Ongoing Costs

25. HMRC estimate that the annual average ongoing costs of handling the additional OECR claims and Gift Aid repayments claims will be in the order of £400,000. This figure is broken down as follows:

Table 2: Additional Annual Cost to HMRC on handling claims from OECR charities

Process	Description	Annual Average Cost*
Stage 1 – Principle Registration	Initial application review: Check applications from organisations are completed correctly and that supporting documents are included. Confirm organisation is in the EU, that it is registered with its domestic regulator and that it satisfies the new definition of a charity.	£100,000
Stage 2 – Fit and Proper Persons	Determine individuals behind the organisation are fit and proper persons. Checking against criminal databases and other sources of intelligence.	Negligible**
Charity Compliance (interventions), Gift Aid Audit (repayment claims)	Review via interventions or Gift Aid Audits non UK organisations.	£200,000

[2] £20.40 per/hr multiplied by 45 minutes.
[3] Council for Voluntary Organisations (NCVO), the UK Civil Society Almanac (2008)
[4] In 2001/02 there were approximately 132,000 general charities. By 2006.07 this had grown to 165,000.

Charity Tax Returns Processing	Tax return processing. This is estimated to peak after 10 years at around 3,000 returns.	£50,000
Gift Aid Repayment Claims	Processing GA repayment claims from non-UK organisations. This will include additional security checks.	£50,000
Total	-	£400,000

*These costs are discounted over a 10 year time frame, using the standard HM Treasury discount assumption of 3.5%
**Negligible in this context implies less than £25,000.

26. After 10 years it is expected that the volume of new EU applications will decline, by which time all current genuine OECRs that are likely to register with HMRC, will have done so. These costs are based on the anticipated increase in the number of staff it will take to process and monitor the additional claims.

Combined Cost Estimates

27. Table 2 below shows the total estimated administrative burden and compliance costs, by main affected group.

Table 3: Summary of Additional Admin Burden & Compliance Costs

Admin Burden/Compliance Cost	One-Off Cost	Annual Average Cost
UK Charities		
International Expenditure	-	£100,000
Increased UK Charity Applications	-	£100,000
HMRC		
Updating HMRC's Systems	£2,000,000	-
Compliance Education	£100,000	-
Annual Recurring Cost of EU Registration and Repayment Claims	-	£400,000
Processing Increased UK Charity Registration Claims	-	Negligible
Total	£2,100,000	£600,000

Key Assumptions / Sensitivities / Risks

28. HMRC estimate the Exchequer cost of extending reliefs to EU charitable organisations could rise to between £150 million to £200 million by 2018-19, by which time full take-up is expected to have occurred. There is a great deal of uncertainty around this cost, in particular, the extent of take-up and possible abuse by EU charitable organisations. Most of the cost is expected to come from abuse and fraud. For this reason, HMRC is taking the steps described to limit the potential risks.

Small Firms

29. The principal change of extending UK charitable tax reliefs to certain eligible EU organisations will not have a specific impact on small UK charities/ businesses. However any decision to limit the number and value of in-year repayment claims, freeing HMRC staff resources to be redeployed on the extra work created by the extension of UK charitable tax reliefs, could have a significant impact on the cash flow of a small number of charities. No decisions have been taken on the limits. HMRC will informally consult with charities on options for reform following Budget 2010.

Competition

30. The Office of Fair Trading competition filters have been applied to these changes and it is concluded that they should have no impact on competition.

Race equality, disability equality, gender equality and human rights

31. An initial equality impact assessment has confirmed that the changes have no negative impacts.

Further Considerations

32. The proposal considered here will have no anticipated impact on; Legal Aid, Sustainable Development, Carbon Assessments, Environmental Issues, Health Issues, Human Rights or Rural Issues.

33. The costs and benefits are only considered for UK donors and charities. We do not consider the administrative burden or compliance cost for EU organisations entitled to charitable tax reliefs or non-UK CASCs.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	**Impact Assessment of implementing the restriction of pensions tax relief**	
Stage: Final	**Version:** 2	**Date:** 24 March 2010

Related Publications: ***Implementing the restriction of pensions tax relief*****, December 2009**
Implementing the restriction of pensions tax relief: a summary of consultation responses, **March 2010**

Available to view or download at:

http://www.hm-treasury.gov.uk/budget2010_impact_assessments.htm

Contact for enquiries: Sarah Miller **Telephone:** 0207 270 5265

What is the problem under consideration? Why is government intervention necessary?

The cost of pensions tax relief has doubled since 1998-99, disproportionately benefiting those on the highest incomes. Rebalancing pensions tax relief is an important element of the Government's fiscal consolidation plan. From April 2011, tax relief on pension contributions will be restricted for individuals with gross incomes of £150,000 and over; tapered down so that it is worth 20 per cent for individuals with gross incomes of £180,000 and over. This will apply to around 2 per cent of pension savers who receive around a quarter of the tax relief on pension contributions.

What are the policy objectives and the intended effects?

This change is necessary to ensure that pensions tax relief remains affordable, and to address the disproportionate amounts of pensions tax relief going to individuals on the highest incomes, so that they receive tax relief on pension contributions at the same rate as a basic-rate taxpayer. It will be implemented in a way that treats defined benefit (DB) schemes fairly in relation to defined contribution (DC) pension schemes and personal pensions, and minimises administrative burdens. Around 98 per cent of pension savers will not be affected by the change.

What policy options have been considered? Please justify any preferred option.

To ensure consistent treatment across pension schemes, a method is needed to deem contributions to DB schemes (doing nothing is not an option). The consultation Impact Assessment considered the impacts of deeming contributions to DB schemes using age-related factors, and cash equivalent transfer value. As announced at Budget 2010, the method of valuation will be age-related factors, with a two-way scale varying with age and normal pension age. Stakeholders generally agreed that this method strikes the right balance between fairness and simplicity. The restriction will be delivered through Self Assessment.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government keeps all legislation under review, and in line with good practice would expect to review the policy within three years.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

'I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs'.

Signed by the responsible Minister: Sarah McCarthy-Fry

Date: 24/03/2010

Summary: Analysis & Evidence

Policy Option: Final	Description: This option estimates the costs of delivering the measure, where DB contributions are calculated via age-related factors (ARFs)

COSTS

ANNUAL COSTS		
One-off (Transition)		Yrs
£ 900m		1
Average Annual Cost (excluding one-off)		
£ £115m		10

Description and scale of **key monetised costs** by 'main affected groups' Ongoing compliance costs for pension schemes, employers and individuals are estimated at £115m for average annual (recurring) costs, and £900m for one-off costs.

Total Cost (PV) **£ £1,850m**

Other **key non-monetised costs** by 'main affected groups'

The Evidence Section discusses potential compliance costs.

BENEFITS

ANNUAL BENEFITS		
One-off		Yrs
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		

Description and scale of **key monetised benefits** by 'main affected groups' The policy contributes over £3 billion per year to the consolidation of the public finances and helps to ensure that the Government's objectives for ensuring fairness, affordability and sustainability of pensions tax relief are met. Net financial benefits are zero as Exchequer yield is a transfer from affected taxpayers.

Total Benefit (PV) **£ 0**

Other **key non-monetised benefits** by 'main affected groups'

The Exchequer yield from this policy is estimated to be in excess of £3 billion per year from 2012-13.

Key Assumptions/Sensitivities/Risks

A range of activities that pension schemes and employers will need to undertake to comply with the policy has been identified to inform estimates and underlying assumptions.

Price Base Year 2010	Time Period Years 10	**Net Benefit Range** (NPV) £ **N/A**	**NET BENEFIT** (NPV Best estimate) **£- 1,850m**

What is the geographic coverage of the policy/option?			UK tax relief recipient	
On what date will the policy be implemented?			6 April 2011	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Neg	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **N/A**	Small **£1,300**	Medium **£1,300**	Large **£6,000**
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ 105m Decrease of £ 0 **Net Impact** £ 105m

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Background

1. The Government provides tax relief on individual and employer contributions to registered pension schemes. Tax relief is available on member contributions to, and investment growth in, occupational defined benefit (DB) and defined contribution (DC) schemes and personal pensions. Employers also obtain tax relief on contributions they make to schemes set up for their employees, and do not pay national insurance contributions (NICs) on contributions they make for their employees' benefit.
2. The Government provides pensions tax relief to encourage and support pension saving in order to help individuals produce an income in retirement. Pensions tax relief is also provided in recognition that pensions are less flexible than other forms of saving, requiring individuals to lock away their savings to produce a retirement income.

Rationale for intervention

3. Pensions tax relief is generous, estimated to be worth around £28.4 billion in 2008-09, roughly 2 per cent of GDP. The cost to the Exchequer net of income tax collected on pensions in payment has doubled since 1998-99. Increasingly, pensions tax relief benefits those on the highest incomes: the restriction will apply to 2 per cent of pension savers or around 1 per cent of working age taxpayers, who currently receive around a quarter of all tax relief on pension contributions. This amounts to around £20,000 per person, which is in stark contrast to the average of £1,000 of tax relief for basic-rate pension savers.
4. Pensions tax relief should be targeted appropriately. It is neither fair nor affordable to grant the biggest incentive to save for a pension to those who need it least. Setting a credible consolidation path to ensure sustainable public finances is a key element of the Government's macroeconomic strategy. The extent of the advantage available to individuals on the highest incomes is not sustainable, particularly in the current fiscal context, and it is against this backdrop that the Government has acted to rebalance the system.

Policy objective

5. The Government's aim is a system of pensions tax relief that is fair, affordable and sustainable. The Government's approach has been specifically targeted at those on incomes of £150,000 and over, due to the disproportionate tax relief on pension contributions that is currently given to this group, which would have been exacerbated by the introduction of the 50 per cent additional rate of income tax from April 2010. While the Government remains committed to the provision of generous tax relief to support pension saving, there is a point beyond which it is no longer fair for taxpayers to provide disproportionately large support for pension saving for individuals on the highest incomes.
6. To this end, the Government announced at Budget 2009 that, from April 2011, tax relief on pension contributions will be restricted for those with incomes of £150,000 and over. The value of tax relief will be tapered down until it is 20 per cent for those on incomes of £180,000 and over, making it worth the same for each pound of contribution to pension entitlement as for a basic-rate taxpayer. This restriction applies to all contributions, including employers' (which already count towards the annual and lifetime allowances).
7. The Government is clear that the restriction of pensions tax relief must apply as fairly as possible to individuals in different types of pension schemes, and with different remuneration arrangements, while remaining targeted on those on the highest incomes. The Government therefore announced at the 2009 Pre-Budget Report that the restriction will

apply to individuals on gross incomes of £150,000 and over, where gross income incorporates all pension contributions including the value of any pension benefit funded by, or eventually funded by, their employer. This avoids favouring individuals who receive significant pension benefits from their employer in their remuneration package, and those with most flexibility to rearrange their remuneration package.

8. To provide certainty for individuals around whether they are affected, and to reduce administrative burdens for employers and for pension schemes, the Government announced that it will introduce a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with pre-tax incomes at or above this level will need to establish the value of any pension benefit funded by (or eventually funded by) their employer. This also keeps the measure well targeted on those with the highest incomes.

9. The Government aims to implement the restriction of pensions tax relief in a way that ensures that DB pension schemes are treated fairly in relation to DC pension schemes and personal pensions, and to introduce the new system in a way that minimises administrative burdens.

Consultation stage Impact Assessment

10. The Government published a consultation document, *Implementing the restriction of pensions tax relief,* at the 2009 Pre-Budget Report. This consultation document set out the core structure of how the restriction will apply. It also asked questions on the implementation of the restriction, and welcomed views on the consultation Impact Assessment, which was published alongside the main document.

11. The consultation stage Impact Assessment considered two policy options around the method used to deem contributions to DB schemes, age-related factors (ARFs) and cash equivalent transfer value, where the first option was considered to be less burdensome for pension schemes as the method is simpler overall.

12. There have been around 100 formal responses to the consultation document, *Implementing the restriction of pensions tax relief*. The responses have engaged on many aspects of the process, including the administrative impacts, and several provided estimates of how they believed the restriction of pensions tax relief would affect their organisations or representative groups.

13. This final Impact Assessment reflects views and evidence put forward during the consultation exercise. As announced at Budget 2010, the DB valuation method will be age-related factors (ARFs), using a two-way scale varying with age and normal pension age (NPA). Therefore, this final Impact Assessment assesses the compliance burdens of the overall process, incorporating the use of a two-way ARFs scale for valuing deemed contributions for individuals in DB schemes. The section titled "Expected Impacts" at paragraph 35 onwards discusses this further.

How the policy will work

14. The vast majority of people will be unaffected by the change, which targets individuals on gross incomes of £150,000 and over (around 2 per cent of all pension savers). The key features of the process for those affected by the restriction of tax relief on pension contributions, their employers and pension schemes are detailed below. They fall broadly into three main steps:

    i) determining income, which shows individuals if they are affected and the amount of relief to which they are entitled;

    ii) determining the pension contributions to which the restriction of relief will apply – where for DB schemes a two-way ARFs scale will apply; and

iii) calculating the size of the restriction and paying any charges to recover excess relief.

15. The restriction of tax relief for individuals with gross incomes of £150,000 and over will be primarily delivered through Self Assessment. This avoids disturbing the net pay arrangements within Pay As You Earn (PAYE), which operate to give most employees tax relief for their pension contributions at the marginal rate of tax; and enables employer contributions to be brought into tax, as for other benefits-in-kind received by employees. All of the individuals affected should already be within Self Assessment.

16. The next section expands on these three main stages – determining income, determining pension contributions, and calculating the size of the restriction and paying any charges to recover excess relief.

i. Determining income

17. Individuals with incomes (excluding the value of any employer pension benefit or contributions) of less than £130,000 are unaffected by this change and will continue to receive tax relief on pension contributions at their marginal rate. Some individuals with incomes (excluding the value of any employer pension benefit or contributions) of £130,000 and over will need to provide additional information to HM Revenue and Customs (HMRC) to calculate and report their gross income and any recovery charges arising from the restriction of tax relief on pension contributions.

18. The Self Assessment tax return will collect information required to determine gross income. The Self Assessment calculation will work out the individual's gross income and position on the taper for those who file online. Paper filers who want to self-calculate will be guided through the necessary steps by accompanying Help Sheets. HMRC will provide clear guidance for individuals and look into providing a toolkit for agents to assist with this process.

ii. Determining pension contributions

19. The restriction of pensions tax relief will apply to all contributions, or deemed contributions for individuals in DB schemes, made in the tax year, including employers' contributions. The total value of contributions from which an individual benefits in a year will also be included in their gross income. Therefore, individuals will need to report details about their own pension contributions and the value of any employer contributions on the Self Assessment tax return. The tax return will be amended to accommodate this information, and HMRC guidance will alert individuals to what they need to do and by when.

20. For DC schemes, it is generally easy to identify contributions made into an individual's pension pot in a given year, by the individual (A) and employer (B). Relief will be restricted on total (A+B) contributions.

Valuing contributions in DB schemes

21. In DB schemes, employers promise their employees a future pension determined by certain factors, typically salary and length of service. Employers then fund their schemes in aggregate or, in the case of some public sector schemes, operate on a pay-as-you-go basis. A method is needed to value a deemed contribution on which to restrict relief, the equivalent of contributions to a DC scheme, taking due account of investment growth which remains exempt from tax. Since DB and DC schemes are not funded in the same way, there is no unique valuation method.

22. The use of ARFs, which was the Government's preferred option as set out in the consultation document, *Implementing the restriction of pensions tax relief,* is also generally preferred by stakeholders who have responded to the consultation. Therefore, as announced at Budget 2010, the DB valuation method will be ARFs, using a two-way scale varying with age and NPA. The Government intends to legislate in the 2010 Finance Bill for

the core ARFs methodology, with provision for the Government to set out the scale of ARFs at a later date through regulations. NPA will, for the purposes of this restriction, be defined as the earliest age at which an individual in a DB scheme has the right to draw an unreduced pension without consent. Where active and deferred NPAs are different, the restriction will be calculated on the basis of the deferred NPA.

23. The ARFs method will value the deemed contribution by:

- adjusting the previous year's accrued pension entitlement by a revaluation rate;
- subtracting this from the current year's accrued pension entitlement; and
- multiplying by the appropriate ARF.

24. In some schemes, members' pensions are divided into tranches which have different NPAs, typically based on service periods. In these cases, it is logical under a two-way ARFs approach that the deemed contribution associated with each tranche should be calculated separately as above, with the ARF applied reflecting the relevant NPA in each case. These deemed contributions will then be aggregated to give a total deemed contribution for the individual.

25. Under the ARFs method, the scheme will need to provide the individual with a certain minimum level of information to allow the deemed contribution to be calculated – that is, an accurate calculation of their annual pension entitlements at the start and end of the year, as well as their NPA and information on any scheme characteristics that may influence the choice of ARF. As discussed in *Implementing the restriction of pensions tax relief: a summary of consultation responses*, the Government believes that it is most appropriate for schemes to calculate the deemed contribution. This is because the pension scheme is most likely to have access to the relevant information and expertise, and will be able to benefit from economies of scale when doing this calculation. Schemes will therefore be required to provide details of the deemed contribution to the individual.

Pension benefits statements

26. To help individuals to determine whether they are affected by the restriction of relief in good time to meet the Self Assessment deadlines, the Government will introduce an obligation on pensions schemes to provide information on pension contributions or deemed contributions to members within three months of receiving a request to do so. To enable this, the Government also intends to oblige employers to provide pension schemes with necessary information on pensionable pay and service within reasonable timeframes, and to request pension benefit statements on behalf of those employees they know to be affected by the restriction of pensions tax relief.

iii. Determining and paying the recovery charge

27. As described above, affected individuals will use the Self Assessment tax return to report information about their individual pension contributions and those made by their employer (or a third party) alongside other information on income to determine the overall rate of relief to which they are entitled. The overall recovery rate is then applied to total pension contributions to calculate the recovery charge.

28. Help Sheets accompanying the Self Assessment tax return will guide paper filers who wish to self-calculate through the calculation process. The Self Assessment calculation will automatically work out an individual's recovery charge for online filers and other paper filers. The amount of excess relief to be recovered as a result of the restriction of relief on pension contributions will be added to the Self Assessment tax bill at the final stage of the calculation of tax due and payable for the year by 31 January in the following year.

29. Where individuals build up particularly large pension entitlements in a year, the current tax relief will be particularly high, so the recovery charges from restricting pensions tax relief will be correspondingly large. Individuals incurring recovery charges of over £15,000 will

therefore have the option of electing that the pension scheme pays the recovery charge on their behalf, with the pension scheme in return reducing their pension pot or their accrued pension benefit for the year by an actuarially appropriate amount (scheme pays). The election will be reported by the individual through Self Assessment, and the scheme pays charge will be accounted for by schemes.

30. The individual will be able to elect for the scheme to pay up to the 31 January payment date for Self Assessment. Schemes will be allowed three months to process elections. This means that if an individual elects for the scheme to pay after the end of October, they will be liable to interest on any late paid tax if the scheme has not received confirmation from them to proceed with the payment by 31 January.

31. Once the individual has made the election for the scheme to pay – and for the scheme to calculate the appropriate reduction in their pension benefits – the key steps in this process will be:

- the scheme calculates the scheme pays charge (which incorporates the grossing-up calculation to reflect the fact that the individual will have benefited from at least basic rate relief on their pension contributions or deemed contributions), and the appropriate reduction in benefits for the member;
- the scheme advises the member of the scheme pays charge and the amount of the reduction in their benefits;
- the member confirms to the scheme that they want to proceed with scheme pays;
- the scheme applies the reduction in benefits; and
- the scheme reports the scheme pays charge to HMRC and pays the tax due. The amount of the recovery charge that the scheme will pay on the individual's behalf will be reported on the individual's Self Assessment tax return.

32. To ensure that individuals wishing to take up the scheme pays option have access to it, and to give pension scheme trustees certainty over the response to member requests for the scheme to pay, it will, in general, be mandatory for schemes to pay the recovery charge if an individual so elects.

33. The Government recognises that in a minority of cases there will be circumstances where it would not be appropriate to allow individuals to opt for the scheme to pay, such as where they are in certain overseas schemes where the foreign law governing them would not permit such a payment, or heavily under-funded DB schemes.

34. Where these circumstances arise, the Government will allow individuals to spread the payment of charges exceeding £15,000 over three years, with interest charged on the deferred amount.

Expected impacts

35. The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration. This section of the Impact Assessment discusses the potential impact on affected parties of the implementation of the restriction of pensions tax relief. It first considers the numbers affected. It then summarises the process for restricting pensions tax relief from the perspective of individuals, employers and pension schemes, estimating the compliance costs for these groups.

36. As part of the consultation exercise the Government welcomed views and relevant evidence to help improve the initial estimates provided in the consultation Impact Assessment. The consultation included several workshops with stakeholders where the options for valuing DB contributions, the steps in the process for scheme pays, and the end-to-end process were discussed. There were also meetings with industry representatives, including focused discussion of the Impact Assessment.

37. As discussed in *Implementing the restriction of pensions tax relief: a summary of consultation responses*, a number of responses contained evidence and views on the Impact Assessment. This evidence has been incorporated as far as possible in the final Impact Assessment, especially in terms of figures relating to the unit costs that correlate closely across different sources.

38. This evidence has been used to refine a number of key assumptions in the analysis of compliance burdens, which is based on HMRC's Standard Cost methodology. The net effect of all the changes made since the publication of the consultation Impact Assessment are an increase of around £595 million in one-off costs and an increase of around £35 million per year in recurring costs.

Numbers affected

39. The restriction of pensions tax relief for those with gross incomes of £150,000 and over will affect around 300,000 individuals. It is estimated that around 110,000 of these individuals will be within DB schemes and 190,000 within DC schemes (including personal pensions), with only a few thousand holding both forms of pension. Based on Office of National Statistics' (ONS) published statistics, it is assumed that the affected individuals in occupational schemes are evenly distributed across around 49,000 schemes (see Table 1). Around 80 per cent of these occupational schemes are classed as small schemes (defined as having fewer than 12 members).

40. There are around 2.1 million employers in the UK, the vast majority of whom are small employers with fewer than 50 employees (see Table 1). Most will not have employees affected by this policy and in fact only an estimated 50,000 employers will be affected (including a small proportion that may incur one-off costs in preparing for the change but ultimately have no affected employees within their organisation).

41. There are also around 10,000 financial advisers that may have clients affected by the measure.

42. As a basis for considering the potential compliance burdens generated by the restriction of tax relief on pension contributions, Table 1 outlines assumptions about the number and size of pension schemes, employers and financial advisers affected by the restriction of pensions tax relief.

Table 1: Estimated numbers affected

	Total	Small	Medium	Large
Individuals	300,000	N/A	N/A	N/A
Pension Schemes of which:	49,600	40,000	7,250	2,350
Personal*	500	–	200	300
Occupational**	49,000	40,000	7,000	2,000
Self-Invested Personal Pensions (SIPPs)***	100		50	50
Employers****	50,000	25,000	15,000	10,000
Financial Advisers	10,000	8,000	1,000	1,000

Source: HMRC, ONS and FSA Statistics.

* HMRC data shows that there are around 100,000 individuals with personal pensions affected by the policy, spread across an estimated 500 providers.

** ONS data from the Occupational Pension Schemes Annual Report, 2007. Estimates exclude schemes that are either classed as frozen or in the process of winding up. Size distributions are based on ONS estimates of membership: small schemes are defined as having fewer than 12 members, medium between 12 and 999 members, and large over 999 members.

*** There are an estimated 0.5 million SIPP policyholders spread across an estimated 100 SIPP providers (source: FSA), assumed to be divided equally between large and medium-sized providers. In practice, some of the costs estimated below may be borne at sub-provider level.

**** Based on HMRC data taking PAYE sources as the employer unit. Small (including "micro") employers here are defined as having fewer than 50 employees, medium between 50 and 249 employees, and large over 250 employees.

Impact on individuals

43. Table 2 summarises the general characteristics of the individuals affected by the restriction of pensions tax relief. The impact is greater on men than it is on women because the majority of those on gross incomes of £150,000 and over are male.

Table 2: Characteristics of individuals affected by the restriction of pensions tax relief

Location:	Around half live in London or the South East.
Gender:	Around 90% are male.
Industry:	Based on standard industrial classification (SIC), around 55% work in financial intermediation (banking, finance and insurance), real estate and business activities (includes a range of business services). Around 85% are in the private sector.
Type of pension:	Around 45% are in an occupational DC scheme, 37% are in a DB scheme and the remainder have personal pensions.

44. The process of determining whether someone is affected, determining pension contributions, and calculating the size of the restriction that individuals will need to comply with is detailed in the previous sections. Affected individuals will need to report this information to HMRC on

their Self Assessment tax return, where necessary requesting specific information from their employer and/or pension scheme. Employees receiving gross pay and taxable benefits of £130,000 or more from their employer will automatically receive the relevant information. Those who are self-employed, or whose income is £130,000 and over but whose salary is lower, will need to request information regarding contributions or deemed contributions from their pension scheme. Currently individuals within net pay arrangements do not report the amount of pension contributions (or those of their employer) on their tax return. This will be a new requirement for all affected individuals within net pay arrangements.

45. The restriction of pensions tax relief will apply to all pension contributions, including those made by employers. In terms of contributions made directly by individuals:

- for those in net pay arrangements who will automatically be given pensions tax relief at the marginal rate on their employee contributions through PAYE, HMRC will collect an amount equal to the appropriate restriction of relief through Self Assessment. This will ensure that individuals do not obtain too much tax relief;
- for those in relief at source arrangements, individuals fully affected by the restriction will not receive any further tax relief (since they will already have received the basic rate relief to which they are entitled). Individuals whose income falls on the taper will have the amount of relief above basic rate relief that they can claim determined by where they fall on the taper; and
- for those making a claim for relief, individuals fully affected by the restriction will be given tax relief at the basic rate and individuals whose income falls on the taper will be given relief at a rate determined by where they fall on the taper.

46. Individuals are not currently taxed on the value of employer contributions made on their behalf, although these are taken into account for the lifetime and annual allowances. Excess relief on employers' contributions will be recouped through Self Assessment.

47. Any recovery charges will need to be paid by the 31 January Self Assessment payment date. Individuals electing for the scheme to pay will need to inform the scheme and record this and the amount on the Self Assessment tax return, and will need to confirm that the scheme should proceed with the payment when details of the offsetting reduction to their pension have been sent to them by the scheme.

Impact on employers

Summary

48. An estimated 50,000 employers will have employees affected by the restriction of pensions tax relief – of which around 20 per cent are large, 30 per cent medium, and 50 per cent small (see Table 1 for size definitions). The impacts per employer will vary depending on how many individuals are affected by the restriction within their organisation, and the types of pension arrangements that they provide for their employees (if any). For instance, many small employers may in fact have quite limited compliance burdens as their employees typically only have personal pensions. In contrast, larger employers may have more than one type of occupational pension arrangement available to their employees. The impacts will also vary depending on the history of the employer, for example whether they have undergone recent mergers that may have complicated their payroll and/or benefit provision. The marginal impact of the restriction of pensions tax relief will also vary. For example, where firms deal with many internationally mobile employees with historical links to other companies, existing payroll and benefit processes may already be complex.

Familiarisation

49. One of the main aspects of the compliance cost for employers will be around familiarisation. There are two aspects to this. The first is the need for management to become familiar with

the new rules. This includes seeking any advice from consultants, actuaries and lawyers. It also includes management having to understand the impact on their business and staff more widely – for example, considering contract material for staff – and potentially discussing at board level or through other forums (such as remuneration committees) in organisations where these exist. Depending on the size of the organisation, it is assumed that employers will spend between 8 hours and 96 hours at senior management level becoming familiar with the new rules and seeking advice, where the longest time is spent in large private sector organisations providing DB schemes. The overall cost for familiarisation at senior management level is around £65 million for some 40,000 employers operating private sector DC schemes, around £30 million for 9,750 employers with private sector DB schemes, and a little under £1 million for 250 public sector employers with DB schemes.

50. The second aspect is ensuring that the organisation is able to deal appropriately with enquiries from employees who are affected, or who seek information (for example, on their income, including benefits-in-kind) to determine their status in relation to the policy. Although in some cases (for example, where employees ask about employer contributions to pension schemes) it will be appropriate to direct employees to their pension scheme for further support, in others employers will likely try to answer queries directly, as the first port of call for employee concerns. Therefore, there will be some information sharing and training exercises required for employers that have dedicated Human Resources (HR) departments.

Literature and guidance

51. Employers may wish to provide targeted communications to the individuals they believe need to consider whether they could be affected by the restriction of pensions tax relief. Employers may also produce more generic communication material on pay and pensions for their employees that will require updating. This will be a one-off cost for employers and is assumed to range between £500 and £2,000 per employer on average. The total one-off compliance cost is estimated at £40 million, £10 million and under £1 million for employers with private sector DC, private sector DB and public sector DB schemes, respectively.

52. There is an element of discretion around how much information and guidance employers choose to provide, and the extent to which senior management is involved. The impacts will therefore vary considerably across employers, and are likely to be highest in the first instance for larger companies, where more individuals are likely to be affected by the measure. They are also likely to be higher for private sector companies providing DB pensions, reflecting the relative complexity of valuing deemed DB contributions compared to DC contributions.

53. The employer compliance cost of dealing with enquiries from employees is divided into one-off and recurring costs. One-off costs are assumed to equate to around 8 man-hours for each employee, at a composite wage of £25 per hour for employers operating private sector DC schemes. For employers operating DB schemes, the assumption is 16 man-hours. This generates one-off costs of £45 million for some 40,000 employers operating private sector DC schemes, around £30 million for 9,750 employers with private sector DB schemes, and around £20 million for 250 public sector employers with DB schemes. Recurring costs are the equivalent of 2, 3 and 4 hours per case for employers operating private sector DC, public sector DB, and private sector DB schemes respectively, charged at a wage of £25 per hour. Total recurring costs are estimated at £11 million, £4 million, and £7 million, respectively.

Information and systems requirements

54. Individuals will need information about their gross pay and taxable benefits from their employer to identify whether they are affected by the measure and then to determine their recovery charge.

55. The consultation document, *Implementing the restriction of pensions tax relief,* proposed a new obligation on employers to request information from pension schemes on behalf of individuals that they identify as being affected by the restriction of pensions tax relief.

56. The Government intends to introduce obligations on employers to provide pension schemes with necessary information on pensionable pay and service within reasonable timeframes, and to request pension benefit statements on behalf of some employees affected by the restriction of pensions tax relief.

57. For some employers, there will also be necessary changes to payroll systems in order to facilitate exchange of information with pension schemes, and to produce benefit statements. Employers currently have an agreed deadline for transferring details of employees' pensionable pay to the scheme administrator. This links in to the scheme year (not necessarily aligned to the tax year). Providing information on pensionable pay to a new timetable for some of the workforce could involve some systems changes; and the information would need to be calculated in a new way (for example, April contributions would need to be apportioned to reflect the end of the tax year). This would be done on top of current processes, unless the scheme year and tax year are already aligned (or are changed to align).

58. For large employers, particularly where benefit statement calculations are already complex, and where employees may have different pension arrangements, these changes may be substantial. Costs are estimated to range from an average of £500 per firm for small employers providing DC pensions, to £10,000 per firm for large employers providing DB pensions. The total cost for changes to payroll systems is estimated at around £40 million for some 40,000 employers operating private sector DC schemes, around £45 million for 9,750 employers with private sector DB schemes, and around £3 million for 250 public sector employers with DB schemes.

Impact on pension schemes

Summary

59. The consultation Impact Assessment was based on an estimated 55,600 pension schemes in operation that would be affected by the restriction of pensions tax relief. Further scrutiny of the status of these schemes has revealed that around 6,000 private sector occupational schemes are either frozen – taking no new contributions and providing no further accruals to members – or in wind-up. These schemes will therefore not be affected by the restriction of pensions tax relief. Accordingly, the total number of occupational schemes affected is reduced to around 49,000. Around 80 per cent of these occupational schemes with affected members will be private sector DC schemes, 19 per cent private sector DB schemes, and 1 per cent public sector schemes.

60. Impacts will vary considerably across schemes. To some extent this will depend on the size of schemes – around 80 per cent are classed as small schemes, 15 per cent medium and 5 per cent large. In some schemes, such as those making use of third party administrators, or in the case of large public sector schemes, there should be some efficiencies of scale.

Familiarisation

61. All schemes will need to become familiar with the new regime. The costs of doing so will vary considerably depending on scheme type, and across the public and private sector. As noted above, DB schemes will typically have higher costs as it is less straightforward valuing a deemed DB contribution than identifying contributions to a DC scheme – whether occupational or personal.

62. As with employers, there are two aspects to the familiarisation. The first is for the managers and trustees of schemes to become familiar with the new rules and to take advice where

necessary from lawyers, actuaries and other types of consultants. It is assumed that, depending on size, pension schemes will on average spend between 8 hours and 64 hours at management level becoming familiar with the new rules and seeking advice, at a composite wage rate of £50 per hour. Typically, it is expected that large private sector DB schemes will spend the longest on this activity. The overall cost for familiarisation at management level is estimated at around £27 million for just under 40,000 private sector DC schemes (including 600 personal pension providers). The corresponding cost to around 9,350 private sector DB schemes is £20 million, and for 250 public sector DB schemes the cost is around £0.6 million.

63. The second set of compliance costs for schemes stem from the need to meet requests from members (whether they are actually affected by the restriction or not), where it will be necessary for schemes to have trained staff at an administrative level that are able to answer queries from individuals.

64. This is expected to generate a combination of one-off and recurring costs for schemes. Given the characteristics of the individuals affected by the restriction (see Table 2) the Government recognises that in some cases individuals may be demanding of scheme administrators, compared with other cases they are normally used to dealing with. Typically, the impacts are expected to be higher for DB schemes than DC schemes. Significant one-off costs are assumed to be limited to DB schemes, assuming an average cost based on 4 hours per case and a composite wage of £40 per hour. Recurring costs for DC schemes assume 2 hours per case at the same wage rate. Recurring costs for DB schemes (private and public) assume double this time (that is, 4 hours per case), again at a composite wage of £40 per hour. Accordingly, the total one-off cost of meeting requests from members is estimated at a little under £15 million for private DB sector schemes and similarly for public sector DB schemes. Recurring costs are estimated at around £30 million for private sector DC, £15 million for private sector DB, and £13 million for public sector DB schemes.

Providing information on pension contributions

65. To determine the size of the charge to recover excess relief, individuals will need schemes to provide them with information regarding their total pension contributions or deemed contributions for the year within three months of being requested to do so by the individual or their employer. This is a new requirement for schemes.

66. DC schemes already provide information about pension contributions to members, though some schemes may need to produce this information to an earlier timescale. Generally, DB schemes currently provide pension benefit statements on the basis of projected future pension rights.

67. The pension benefit statements will need to relate to contributions or deemed contributions made over a tax year, which is the relevant ‘pension input period’ for the restriction of relief. There will be some additional compliance costs for schemes in transitioning to a new (or additional) pension input period for some or all of their members, where this is not aligned with the tax year. The new pension input period will require initial systems changes.

68. The impact of moving to a new pension input period is a one-off cost, with any recurring impact from producing statements on the tax-year basis reflected in the sections on familiarisation and DB valuation. The one-off cost will vary considerably across schemes, and, depending on size, is assumed to range from £1,000 and £5,000 per scheme for DC schemes (including personal pensions), to £2,000 and £10,000 per scheme for DB schemes. Where schemes are administrated by third party administrators, the average cost may be lower. The total one-off compliance cost is estimated at £42 million, £40 million and £3 million for private sector DC, private sector DB and public sector DB schemes, respectively.

DB valuation using ARFs

69. As discussed in *Implementing the restriction of pensions tax relief: a summary of consultation responses*, the Government intends to legislate for a two-way ARFs scale, varying with age and NPA, where NPA for the purposes of this restriction is defined in paragraph 22. It is expected that some schemes will have to seek legal advice to clarify the NPA that is applicable for the restriction of pensions tax relief.

70. For the purposes of producing member benefit statements, currently schemes often do this calculation on a projected basis, making certain assumptions about the future to give the individual an indication of what their future pension might be under certain circumstances. Therefore, it is likely that schemes will incur initial set-up costs to computerise the specified calculation of accrued benefit, which feeds into the calculation of the deemed contribution. However, this calculation is similar to what is required when an individual leaves a scheme, so this will not be entirely new to schemes.

71. It is also likely that schemes will incur set-up costs to computerise the final stage of the process. For schemes that opt for this approach, ongoing costs of producing the calculations for each individual will then involve running the computerised process. Some schemes will carry out these calculations manually, which will typically involve a higher recurring cost. However, it is assumed that the majority of large schemes will move to an automated process.

72. This process will be carried out by scheme administration staff with some assistance from senior staff and expert advisers. It is assumed that to carry out the ARFs valuation schemes will take an average of between 2 and 5 hours per member, at an average wage of £40 per hour. This average recognises the use of both manual and automated processes across schemes, and the use of third party administrators by some schemes. The total one off costs of moving to ARFs is estimated at £75 million for private sector DB schemes and £8 million for public sector DB schemes. The estimated recurring costs are £9 million and £5 million, respectively. For DB schemes, compliance impacts around familiarisation and providing information and guidance account for the ARFs valuation method.

Scheme pays

73. As discussed in *Implementing the restriction of pensions tax relief: a summary of consultation responses*, where individuals have recovery charges exceeding £15,000, they will be able to elect for the scheme to pay the charge. This option will be available to members of both DB and DC schemes.

74. Where schemes have to pay the recovery charge on an individual's behalf they will incur both one-off and recurring compliance costs.

75. Once the member has elected for the scheme to pay, and the scheme has made an initial agreement with the member, the scheme will need to calculate what this would mean for a corresponding reduction in benefits on an actual basis for members of DC schemes, and an actuarially fair basis for members of DB schemes. For DB schemes, the process of making an offsetting adjustment will require changes to scheme rules and schemes may seek legal advice on this. The process will also require some systems changes.

76. When the individual confirms that the scheme should proceed with the payment, the scheme will then report and pay the scheme pays charge on the individual's behalf via the existing Accounting for Tax route, which will be modified to accommodate this.

77. The cost of operating scheme pays will vary considerably by scheme, partly because not all schemes will find that members take up or are eligible for the option. It is estimated that around 60,000 individuals will be eligible for scheme pays across different types of pension schemes and employment. Of these 60,000 individuals, it is assumed that around two-thirds take up the option. There are two main aspects of the compliance burden for the scheme – communications with the member, and the reduction of the pension benefit. One-off costs

are assumed to range from £2,000 for small private sector DC schemes up to £50,000 for large private and public sector DB schemes.

78. Recurring costs assume that private sector DC schemes will need to spend around 4 hours dealing with each case at a composite wage of £40 per hour, while public sector DB schemes will spend an average of 12 hours per case and private sector DB schemes an average of 20 hours per case. Total one-off costs for scheme pays are estimated at £95 million for private sector DC, £90 million for private sector DB, and £12 million for public sector DB schemes. Recurring costs are estimated at around £3 million, £14 million and £3 million, respectively.

Financial Advisers

79. Financial advisers will also incur costs in terms of becoming familiar with the new rules and undertaking one-off training to enable them to provide appropriate advice following the changes to the pension rules. The estimates assume that, on average, financial advisers will spend between 8 and 48 hours across small, medium and large organisations in becoming familiar with the new rules at an average wage of £50 per hour. Training is assumed to cost around £500 per financial adviser, assuming 1, 10, and 50 individuals will undertake training within small, medium and large financial adviser organisations, respectively. The total one-off compliance cost for financial advisers is estimated at around £10 million.

Summary of all costs

80. The consultation exercise has gathered in valuable evidence and views from industry experts, which together suggest that some compliance costs will be higher than reported in the consultation Impact Assessment published at the 2009 Pre-Budget Report. In recognition of this, this final Impact Assessment presents revised estimates for the compliance cost of the restriction of pensions tax relief which total £900 million of one-off costs and £115 million of recurring costs.

81. The final Impact Assessment also demonstrates the substantial differences that are likely across different organisations, depending largely on their different sizes and structures. The compliance burdens will in part be driven by the proportion of individuals within each organisation (or members within each pension scheme) who are affected by the changes to pensions tax relief. While many small employers and pension schemes will be significantly affected by the implementation of the restriction of pensions tax relief, the expected impact will typically be greater for larger employers and pension schemes, who will tend to have more affected individuals within their organisations.

82. For both employers and pension schemes, the time spent becoming familiar with the new regime will be higher than initially estimated. In addition, the Government recognises that there will be significant one-off costs incurred at management level. These, together with revised one-off costs for providing information and meeting general requests for information, generate higher overall compliance costs for employers than presented in the consultation Impact Assessment. Total one-off costs for employers are estimated at around £330 million, and recurring costs for employers are estimated at around £22 million per year.

83. For pension schemes, one-off costs will also be higher than originally envisaged. Schemes are estimated to incur one-off costs of around £48 million for management familiarisation and advice, and £30 million for meeting requests from members. One-off changes to pension administration are also expected to cost an estimated £117 million, while the move to a new pension input period adds an estimated £85 million, and operating scheme pays an estimated £197 million to the one-off costs of pension schemes. Again, these cost estimates recognise that across different types of schemes the one-off burden will vary considerably (for instance there is up to six -fold variation across small and large schemes).

84. Estimated recurring costs for pension schemes have also been revised. The recurring costs for meeting requests for members are estimated at £30 million for private sector DC schemes, £15 million for private sector DB schemes, and £13 million for public sector DB schemes – giving a total of £58 million per year. Other recurring costs relate to undertaking DB valuations and operating scheme pays. Total recurring costs across all pension schemes are estimated at around £92 million per year.

85. HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular: the administrative burden on business of disclosing information to HMRC or to third parties. This burden is assessed through the 'Standard Cost Model' (SMC), an activity-based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs. The Impact Assessment template requires SCM figures to be presented in May 2005 prices, as administrative burden reduction targets relate to a May 2005 baseline. The Impact Assessment also uplifts those figures to current day prices. The recurring costs presented in this Impact Assessment are £115 million in current prices, all of which are costs to business of providing information to third parties. They therefore represent an increase in administrative burden of £105 million per year in 2005 prices.

Competition Assessment

86. The measure applies to all individuals with gross incomes of £150,000 and over who opt to make or benefit from pension contributions. Sectors with proportionately more high-income workers will also have proportionately more individuals affected by the policy. However, the policy itself applies in equal measure across firms within any given industrial sector. Accordingly, the Government does not anticipate any material impact on competition.

Small Firms Impact

87. The measure applies to individuals with gross incomes of £150,000 and over who opt to make pension contributions and does not seek to differentiate according to the size of firms within which the affected workers operate. Given that around 98 per cent of UK employers operate with fewer than 50 employees, a majority of the affected firms will be small employers, even though the overwhelming majority of individuals affected (estimated at around 70 per cent of affected individuals) will work for medium and large employers. The compliance costs for small employers will differ from those of relatively larger employers, given differences in systems and processes.

Impacts on financial services

88. Financial services providers will need to train their advisers so that they are able to provide the appropriate advice on the restriction. Paragraph 79 discusses the impacts on financial advisers.

Impacts on HMRC

89. The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration. HMRC will need to modify both the Self Assessment tax return and Accounting for Tax systems to calculate and recover any excess tax relief on pension contributions and accommodate the facility to spread the recovery charge, and to enable the scheme to pay recovery charges on an individual's behalf. Existing guidance for both Self Assessment and the Accounting for Tax process will need to be revised and additional guidance will be required to help individuals and scheme administrators with their obligations.

90. HMRC anticipate incurring additional costs in making systems changes, communicating the reform, and in terms of extra queries from individuals and their advisers, and pension schemes. Staff will need to be trained to deal with such queries. The measure will cost HMRC around £3 million per year to enforce. This will be an integral part of HMRC's ongoing compliance and monitoring activities.

Other impacts

91. This reform was initially assessed for its likely impact on legal aid, sustainable development, health, race, disability, gender or human rights issues, and for its effect on rural areas, and it was concluded that it does not impact significantly upon them. Based on internal and external data available there is no reason to believe that this reform would affect people differently based on their equality group. The Government does not therefore propose to undertake a full equality Impact Assessment.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency: HM Treasury	**Title:** Impact Assessment of increasing the climate change levy (CCL) reduced rate in order to comply with State aid rules	
Stage: Final proposal	**Version:** 1	**Date:** 24 March 2010
Related Publications: N/A		

Available to view or download at:

http://www.hm-treasury.gov.uk

Contact for enquiries: Nick Hatherall **Telephone:** 020 7270 6106

What is the problem under consideration? Why is government intervention necessary?

The reduced rate of CCL, claimed by facilities in the Climate Change Agreement (CCA) scheme, is a State aid. The CCL on reduced-rated supplies of gas and solid fuel is below the minimum levels set by EU law. By 1 April 2011, when existing CCA State aid approvals expire, the levy payable on all reduced-rated supplies must be above the EU minima. If not, the UK would need to submit State aid notifications covering all CCA sectors and secure approvals to enable each to continue claiming the CCL relief. Without making a change there is a risk that the CCA scheme would end prematurely as approvals may not be granted.

What are the policy objectives and the intended effects?

The policy objective is to ensure that the levy paid on reduced-rated supplies of all taxable commodities is above the applicable EU minima, without adding complexity to the reduced-rate regime.

This will entitle the UK to use a simplified procedure for State aid clearance, thereby relieving government and industry of the significant burden of submitting full notifications. It will also provide participating businesses with certainty that the reduced rate will continue beyond 31 March 2011, so maintaining the strong environmental impact of the CCA scheme.

What policy options have been considered? Please justify any preferred option.

Option 1: Increase the reduced rate for all taxable commodities. This is the **preferred option** to be introduced. It ensures that businesses that do not participate in the CCA scheme will be unaffected. It also maintains the administrative simplicity of a single reduced rate.

Other options considered and rejected:

Option 2: Do nothing. This option risks the premature exit from the CCA scheme of some or all of the existing sectors.

Option 3: Increase the rates at which the levy is payable on supplies of all taxable commodities.

Option 4: Increase the reduced rate for gas and solid fuel only.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? HMRC will conduct a post-implementation review within 3-5 years of introduction.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Sarah McCarthy-Fry

Signed by the responsible Minister:

Date: 24/3/10

Summary: Analysis & Evidence

Policy Option: 1 **(Preferred option)**	**Description: Increase the reduced rate for all taxable commodities**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Up to 9,000 CCA facilities may be required to submit relief certificates (PP11) to their energy suppliers and also to HMRC (including the Supporting Analysis PP10 form) for each taxable commodity. There would be an estimated one-off cost to relief recipients of £1,210,000 and £43,000 for energy suppliers.
£ 1.30m	1	
Average Annual Cost (excluding one-off)		
£ Nil		**Total Cost** (PV) **£ 1.30m**

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Full State aid approval would not be required since the conditions of State aid simplification would be met. Detailed and administratively burdensome State aid notifications would not be required. The CCA scheme would remain. Additional carbon savings are also expected to amount to £0.85m per annum or £4m over five years in net present value.
£ Nil	1	
Average Annual Benefit (excluding one-off)		
£ 0.85m		**Total Benefit** (PV) **£ 4 m (but see below)**

Other **key non-monetised benefits** by 'main affected groups' This option would meet the criteria for State aid simplification. The additional CCL burden would fall on CCA sector participants only. Avoiding the submission of full State aid notifications helps save a potential one-off compliance cost for businesses and Government combined of about £6.5m.

Key Assumptions/Sensitivities/Risks Assumes CCA scheme continues uninterrupted. This option is expected to increase the amount of CCL collected by up to £40 million in 2011-12 rising to £50 million annually thereafter.

Price Base Year 2011	Time Period Years 5	**Net Benefit Range** (NPV) **£ –**	**NET BENEFIT** (NPV Best estimate) **£2.7 m (Incl. carbon savings)**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			1 April 2011	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			No change	
Does enforcement comply with Hampton principles?			Not Applicable	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			Not Applicable	
What is the value of changes in greenhouse gas emissions?			£ 0.85m p.a. (better)	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **Nil**	Small **Nil**	Medium Nil	Large **Nil**
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)					(Increase - Decrease)
Increase of	£ Nil	Decrease of	£ Nil	**Net Impact**	**£ Nil**

Key: **Annual costs and benefits: Constant** **(Net) Present Value**

Evidence Base (for summary sheets)

1. The issue

In 2001, State aid approval was granted for the climate change agreements (CCA) scheme. The approval covered more than 40 sectors undertaking processes covered by the Pollution, Prevention and Control (England and Wales) Regulations 2000 (the PPC Regulations). In 2005 the European Commission approved extended eligibility criteria for the scheme allowing a further 12 sectors to join between 2005 and 2007. Although the CCA scheme was originally designed to run until 2013, both sets of CCA State aid approvals expire on 31 March 2011. Re-approval is therefore required for the final two years of the current scheme.

At Pre-Budget Report (PBR) 2007, the Government announced its intention to extend the CCA scheme to 2017, subject to State aid approval.

In 2008 the EU Commission published new guidelines for assessing whether State aids for the purposes of environmental protection are allowable and introduced a General Block Exemption Regulation. The combined effect of these changes is that it is now no longer necessary to submit a formal State aid notification, where:

- the tax in question is a harmonised tax;
- the conditions of Directive 2003/96/EC are fulfilled; and
- after the tax reduction, the tax payable by the aid beneficiaries is above the minimum rates set by the Directive.

If these conditions are not met, the Member State must submit a full State aid notification to the Commission demonstrating that challenging necessity and proportionality tests are met.

Although the main rates of all CCL taxable commodities are comfortably above the EU minima, gas and solid fuel, when taxed at the reduced rate, are currently below. While this situation continues, any future State aid notifications for the scheme would involve the gathering and submission of detailed information about customer segmentation – a complex and highly resource intensive process for both industry and government with no guarantee that the Commission would be fully satisfied with the evidence provided.

When, in 2008-09, the Government sought to bring the plastics sector into the CCA scheme under the new State aid guidelines, it was unable to satisfy the Commission that the necessity test was met. Legislation was therefore introduced in Finance Bill 2009, giving the Department of Energy and Climate Change (DECC) powers to limit participants' entitlement to claim the reduced rate to electricity and liquefied petroleum gas (LPG) only. This temporary solution enabled us to admit the plastics sector to the CCA scheme. It is crucial to both the continuance and credibility of the CCA scheme that the levy paid on all commodities when taxed at the CCL reduced rate is above the EPD minimum rates. There are three important reasons for making the announcement at (PBR) 2009:

- Business are demanding that the Government send a clear signal at PBR that they are serious about resolving the State aid issue to give sectors the certainty and confidence to plan for long-term energy efficiency measures.
- Given our experience with the plastics sector (for which we had still received no firm decision from the Commission 11 months after the notification had been made) there is a strong risk that, if no decision were announced at PBR, there would be insufficient time to prepare and present full State aid notifications, deal with any questions the Commission might raise and secure approval. Affected CCA sectors could, consequently, forfeit the opportunity to continue claiming the reduced rate of CCL after 31 March 2011.
- DECC would be able to develop a clearer strategy on the future of the CCA scheme during subsequent consultations, planned for 2010, to maximise the environmental

effectiveness and simplicity of the scheme.

2. Communication with industry

Industry is well aware of the issue outlined above and is lobbying strongly for the Government to send a clear signal at PBR that it is serious about resolving it. This will give affected sectors the confidence to plan and invest in long-term energy efficiency measures. Postponing action on the issue would increase business uncertainty around the continuation of the CCA scheme, would likely lead to investment blight, and increase the risk of 'carbon lock in'.

Industry sectors have expressed a preference for increasing the reduced rate of CCL, rather than increasing CCL main rates, in order to avoid the administrative burden of submitting the detailed evidence base necessary to support full State aid notifications, which would have no guarantee of success. However, industry has indicated that they prefer Option 4 as a means to solving the issue. Our reasons for choosing to implement Option 1 ahead of this are outlined in the analysis below.

3. Policy Proposal

This policy aims to minimise the costs and complexity of the approval process as far as possible, and ensures the CCA scheme can continue to operate, fully complying with the EU energy taxation and State aid frameworks, whilst maintaining the considerable carbon savings the scheme provides.

The Government will implement the following changes:

- **Increase the reduced rate on all taxable commodities from 20 per cent to 35 per cent with effect from 1 April 2011**. This will ensure the conditions of the State aid simplifications are met by the time the State aid clearance for the CCA scheme is due to be extended.
- **Require businesses affected by this change to submit new PP11 relief certificates to their energy suppliers**. Businesses eligible to claim the reduced rate and certain CCL exemptions do so by certifying to their energy supplier the overall percentage of relief to which they are entitled. Businesses claiming reliefs in this way must review their overall entitlement each year, but are not obliged to give their supplier a new certificate until the original is 5 years old, even though the level of their overall entitlement may change during that period. Obliging businesses affected by the increase in the reduced rate to give their suppliers new certificates at the time of the change in rate will ensure they pay the correct amount of levy from 1 April 2011.

4. The Options

Option 1 – Increase the reduced rate for all taxable commodities (preferred option)

The preferred option to be introduced is to increase the reduced rate from 20 per cent to 35 per cent with effect from 1 April 2011. In practice this changes the maximum CCL relief from 80 per cent to 65 per cent on qualifying energy consumption. This option would give businesses in the CCA scheme certainty that the scheme, and thus their entitlement to claim the reduced rate, could continue after 31 March 2011. The environmental benefits arising from the scheme would also be maintained.

This option offers a well-targeted approach to overcoming the obstacle to re-approval of the CCA scheme presented by the State aid guidelines since only CCA participants would incur the impact of the changes, leaving businesses outside the scheme unaffected by any of the increases to CCL main rates of option 3. Increasing the reduced rate across all taxable commodities avoids introducing new complexities for both business and HMRC (who are responsible for assuring the compliance of the reduced rate of CCL).

This option would generate additional CCL revenue of £40 million in 2011-12 and £50 million annually thereafter. This would lead to a marginal average increase in operating costs across all sectors by around 0.03 per cent. 'Clay products, cement, lime and plaster' and 'paper and plastics' sectors would face the highest increase in operating costs at around 0.28 per cent and 0.12 per cent respectively. The increase in the tax receipts would largely come from steel (£15 million), food and drink (£5 million), chemicals (£5 million), aluminium (£5 million) and paper (£3 million).

The cost and benefits figures given below for all the policy options are estimates measured against the current compliance costs incurred by businesses and the Government under the current CCL/CCA regimes.

<u>Compliance and administration costs</u>

Transitional and one-off costs

There would be some one-off familiarisation costs associated with this option. All CCA participants would need to familiarise themselves with the new arrangements and we would expect this to be done at all 9,000 facilities. Assuming an hourly rate of £20.00 the total one-off familiarisation cost is estimated to be around £360,000 based on spending 2 hours at each facility.

For each taxable commodity, businesses eligible to claim the reduced rate do so by giving a PP11 supplier certificate to their energy suppliers and a copy of the PP11 and a PP10 Supporting Analysis certificate to HMRC. This process is also used by businesses to claim other non-CCA reliefs and exemptions. The energy supplier must give HMRC a summary of the PP11 certificates received within 90 days of their receipt. The exact number of certificates required solely for CCA relief entitlement is not known and so throughout this Impact Assessment, we have estimated that 16,000 PP11 and 16,000 separate PP10 certificates are needed.

To ensure they claimed the correct amount of CCL relief, businesses in the CCA scheme would need to recalculate their overall relief entitlement using the new reduced rate and, notify that revised entitlement to their suppliers by providing a fresh PP11 certificate for each taxable commodity supplied. In addition, each relief recipient would have to provide a copy of the PP11 and PP10 supporting analysis to HMRC.

In response to each fresh PP11 certificate received, energy suppliers would have to amend individual customer records to note the applicable new relief entitlement and within 90 days provide HMRC with a summary of the certificate.

HMRC assess the "administration burden" through the "Standard Cost Model" (SCM), an activity-based costing methodology which considers the activities that businesses need to undertake to comply with their legal obligations, and estimates the cost of such activities.

The estimated administration costs of completing and submitting the relief certificate to energy suppliers and HMRC is £850,000 based upon 9,000 CCL relief claimants submitting 16,000 PP10 and PP11s after adjusting for the time saving arising from completing similar forms for more than one taxable commodity.

The estimated cost of energy suppliers amending their customer accounts with the new CCL relief percentage is estimated to be about £20,000. This is based upon 16,000 customer accounts being amended and taking about 5 minutes per CCL customer at an hourly rate of £15.

Assuming 16,000 PP11 certificates were sent to the energy suppliers informing them of a new relief rate, it is estimated that the administrative burden to provide HMRC with a summary of the PP11 would be approximately £21,000 or £26,000 if postage were included for every certificate.

There would be some transitional costs for HMRC under this lead option, including amending published guidance.

On-going costs

Under this option, there would be no additional continuing costs for relief claimants. After the initial change to the reduced rate relief claimants would then apply the compliance rules in the same way as before the changes.

HMRC would incur continuing compliance costs ensuring relief recipients apply the new reduced rate correctly and that they inform their energy suppliers of the changes to their relief entitlement.

Compliance and administration benefits

Detailed and administratively burdensome State aid re-approval procedures would be removed since the conditions of State aid simplification would be met. CCA sectors and their sector associations and HMRC would not incur the burden of the application procedure for the approval of State aid.

There is an environmental benefit of about £0.85 million a year or £4 millions over five years in present value resulting from the expected carbon savings under this option.

The net present value (NPV) cost and benefit figure quoted in the Summary: Analysis & Evidence of this Impact Assessment is based on a 5-year period, using a discount rate of 3.5 per cent, with year 2011-12 as the starting year.

Option 2 – Do nothing

To secure approval enabling the 54 industry sectors covered by the CCA scheme to continue benefiting from the reduced rate of CCL it would be necessary to submit full State aid notifications. This would require the gathering and presentation of detailed information about customer segmentation - an administratively burdensome and time-consuming process for both the sectors and government, with no guarantee that the Commission would be sufficiently satisfied to give approval. Until the Commission gave its final decision, the sectors and their members would face a time of uncertainty impacting on their ability to plan for the future.

If none of the sectors were re-approved the CCA scheme would come to a premature end on 31 March 2011, requiring all energy-intensive businesses to pay CCL at the full rates.

Taking no action would also have an environmental impact. The CCA scheme provides a cost-effective way for the energy-intensive, internationally exposed businesses to achieve the targets in energy efficiency and emission reduction with relatively moderate effects on their competitiveness. If the scheme were to be withdrawn, these businesses would be subject to the full CCL rates and hence face higher energy prices. Carbon savings may still be achieved, depending on how these businesses adjust their energy consumption in response to the price changes. However, these adjustments would be more costly and have larger impacts on their international competitiveness.

Compliance and administration costs

Transitional and one-off costs

Under this option preparing and supporting the State aid notifications necessary to seek re-approval would involve significant and immediate burdens upon the business sectors and Government, with no guarantee that the Commission would be fully satisfied with the evidence provided. Although the accumulative administration costs for State aid re-approval are uncertain, using a central estimate of £120,000 per sector (including sector association, members and government officials) suggests an overall estimate of around £6.5 million for the existing 54 sectors although this analysis is sensitive to assumptions and the individual sector costs may vary considerably depending upon their size and complexity.

If, as a consequence, any or all of the sectors were unable to secure re-approval and their entitlement to the reduced rate was therefore withdrawn, businesses within affected sectors would incur one-off compliance and administration burden costs because they would need to notify their energy suppliers of the change to their CCL relief entitlement.

Should none of the sectors secure re-approval all relief recipients would be required to notify their energy suppliers that they should no longer receive the CCA reduced rate applied to their energy consumption. Some relief recipients would still be entitled to other non-CCA reliefs and would be required to provide an amended PP11 to their supplier and the PP11 and PP10 Supporting Analysis to HMRC. For those CCA relief recipients no longer entitled to any CCL relief a new PP11 supplier certificate showing a nil percentage of relief would be required by their energy supplier and HMRC.

The one-off administration burden cost for CCA relief recipients if none of the sectors secured re-approval is estimated to be £275,000. This is calculated using the SCM methodology by assuming that the relief should no longer be applied to around 14,500 customer accounts and that 1,500 new or amended certificates should be provided to energy suppliers and HMRC. Energy suppliers receiving amended relief certificates are required to deliver a copy of this information to HMRC within 30 days of receipt; the cost of this administrative burden, including postage costs for each certificate, is estimated to be £2,500 based upon spending 5 minutes at £15 per hour for 1,500 accounts or up to £27,000 for all 16,000 accounts.

In addition, the energy suppliers, who are responsible for charging and accounting for the levy due on taxable commodities, would have to amend individual customer records to note the applicable new relief entitlement, or to note that the customer was no longer entitled to any relief at all. This administration burden using the SCM is estimated to be around £20,000 based upon about 5 minutes per CCL customer account to be amended and an hourly rate of £15.

Should some but not all the sectors secure re-approval the above CCA relief recipients' administrative burdens costs as a whole would be reduced accordingly.

There would be no immediate additional CCL incurred as a result of this option but, if entitlement to the reduced rate had to be withdrawn with effect from 1 April 2011, affected sectors would incur additional CCL from that date. Using current rates, and assuming a worst-case scenario of no sectors securing re-approval, the overall additional CCL payable would be up to £200 million in 2011-12 rising to £270 million in 2014-15.

A small number of facilities that failed to meet their 2010 CCA targets, and which were in sectors that failed to meet their sector level targets, may have to repay CCL to HMRC under the recovery provision introduced in Finance Act 2009. The recovery provision was a requirement of the current State aid approval and was introduced to maintain the incentive on facilities to meet environmental targets in the event that re-approval for the CCA scheme from 1 April 2011 was not secured. The provision applies to certification periods starting on or after 1 April 2009 and enables HMRC to recover levy in proportion to the extent to which each affected facility falls short of its target.

If State aid approval were not to be renewed the CCA scheme would be withdrawn as continuing with the scheme without State aid approval would contravene EU law.

On-going costs

Under this option, there would be no additional continuing costs and the administrative burdens of compliance with the reduced rate certification regime would cease to be a continuing burden for CCA scheme participants who receive no other CCL relief. The SCM (using 2005 prices) shows this continuing baseline cost to be £7,000 based upon just 135 relief certificates whereas the actual number of certificates received by HMRC is approximately 5,000 in total (PP10 plus PP11) suggesting an estimated continuing administration burden of £160,000 for relief recipients and £7,200 for energy suppliers (using 2009 prices).

HMRC would incur no additional continuing costs and minimal transitional costs. The costs of assuring the compliance with the CCL reduced rate would be removed.

<u>Compliance and administrative benefits</u>

If the CCA scheme were withdrawn the administrative burdens of relief recipients performing annual reviews and the requirement to inform energy suppliers and HMRC of any changes to their reduced rate relief entitlement would cease. Businesses would no longer be required to co-operate with HMRC compliance interventions. The removal of these burdens would be a benefit to the businesses, estimated to be about £175,200 in 2009 prices (see the paragraph under *On-going costs* above).

If the CCA scheme were withdrawn, HMRC would no longer need to maintain guidance in respect of the CCL reduced rate. It would be unnecessary to maintain records of the relief certificates and HMRC compliance costs would be reduced.

Option 3 – Increase the rates at which the levy is payable on all taxable commodity supplies.

This option is to increase the CCL main rates on supplies of all taxable commodities by approximately 60 per cent. This option would increase total revenues from CCL by £400 million in 2011-12.

This change would overcome the State aid issues outlined above and allow for any fluctuations in exchange rates. Businesses within the CCA scheme would be secure in the certainty that they could continue to claim the reduced rate beyond 31 March 2011. The incentive on them to make continuing energy savings or emissions reductions would be preserved and even strengthened. However, this would not be a well-targeted approach since businesses outside of the CCA scheme, who are unaffected by the State aid issues outlined above, would be required to pay significantly higher rates of CCL of up to £362 million.

<u>Compliance and administration costs</u>

Transitional and one-off costs

Energy suppliers, who are responsible for charging and accounting for the levy due, would have to amend their accounting system to ensure that the new CCL rate for each taxable commodity supplied after the change in rates was correctly applied to the customer's bill. However, this would be no different to the action they must take whenever the main rates change. HMRC estimate this one-off cost to be around £325,000 based upon 180 energy suppliers adjusting two accounting systems for two taxable commodities taking an average of 2 days at £30 per hour. This estimate assumes that these amendments will be performed by employees of the energy supply companies. If external IT contractors were required this estimate may be significantly higher. CCL payable on any supplies spanning the change of rates would need to be adjusted and accounted for correctly. Where there is a supply of gas or electricity spanning a change in rates, paragraph 37 of Schedule 6 to the Finance Act 2000 allows that a taxable person may elect to determine the rate according to set rules. This election should be made in writing to the Commissioners. The SCM estimates this administration burden to be £14.50 per election at 2005 prices. Some energy suppliers have special accounting agreements with HMRC, known as Special Utility Schemes, which may also require additional adjustment to ensure the correct amount of CCL was paid at the right time.

All consumers of taxable commodities would bear the increased CCL rates of this option not just those participating in the CCA scheme. Energy costs would therefore increase and some, albeit a small number, of businesses' purchase systems may also require amendments to deal with the new rates as well as providing management information regarding the impact of the increased rates which may in turn lead to some energy consumption efficiencies. In 2009 there are 2.6 million businesses (ONS: Inter Departmental Business Register) in the UK of which approximately 2 million are registered for VAT. Some or all of these businesses would incur some costs in administering any changes to the CCL rates.

HMRC computer systems would require updating to reflect the changes to CCL rates; however, the cost of these changes is minimal. Providing advice and guidance on changes to the CCL system is a routine part of HMRC's business and does not represent an additional cost to HMRC.

On-going costs

Under this option, there would be no additional continuing costs.

HMRC would incur no additional continuing compliance costs.

Compliance and administration benefits

Detailed and administratively burdensome State aid re-approval procedures would be removed since the conditions of State aid simplification would be met. CCA sectors and their sector associations and HMRC would not incur the burden of the application procedure for the approval of State aid.

Option 4 – Increase the reduced rate for gas and solid fuel only

An alternative option would be to restrict the new reduced rate to gas and solid fuel, leaving the reduced rate for electricity and LPG at 20 per cent. Like option 1, this would overcome the obstacle to re-approval of the CCA scheme presented by the State aid guidelines, but unlike option 1 it would introduce an added layer of complexity to the mechanism for giving the CCL discount, with associated concerns about compliance. This is because CCA participants claiming the reduced rate would have to deal with two reduced rates, 20 per cent and 35 per cent, with the risk that the wrong one could be used when calculating their entitlement to relief on individual taxable commodities.

This option would generate additional CCL revenue of £10 million annually when compared with the current position.

Compliance and administration costs

Transitional and one-off costs

There would be some one-off familiarisation costs associated with this option for those CCA participants that claim a reduced rate on their gas and/or solid fuel consumption. These CCA participants would need to familiarise themselves with the new arrangements and we would expect this to be done at approximately 4,100 facilities. Assuming an hourly rate of £20.00, the total one-off familiarisation cost is estimated to be around £164,000 based on spending 2 hours at each facility.

To ensure they claimed the correct amount of CCL relief, businesses in the CCA scheme would need to recalculate their overall relief entitlement for supplies of gas and solid fuel, using the new reduced rate and notify that revised entitlement to their suppliers by providing fresh PP11 certificates. In addition, each relief recipient would have to provide a copy of the PP11 and supporting analysis (PP10) to HMRC.

When undertaking the annual review of their overall relief entitlement, claimants would again need to ensure they had applied the correct reduced rate to each taxable commodity supplied.

In response to each fresh PP11 certificate received, energy suppliers would have to amend individual customer records to note the applicable new relief entitlement and within 90 days provide HMRC with a summary of the certificate.

The estimated administration costs of completing and submitting the relief certificate to energy suppliers and HMRC is £500,000 based upon CCA relief claimants submitting 8,000 PP10 and PP11s after adjusting for the time saving arising from completing similar forms for more than one taxable commodity.

The estimated cost of energy suppliers amending their customer accounts with the new CCL relief percentage is estimated to be about £10,000. This is based upon 8,000 customer accounts being amended and taking about 5 minutes per CCL customer at an hourly rate of £15.

Assuming 8,000 PP11 certificates are sent to the energy suppliers informing them of a new relief rate, it is estimated that the administrative burden to provide HMRC with a summary of the PP11 would be approximately £10,000.

There would be some transitional costs for HMRC under this option, including amending published guidance.

On-going costs

Under this option, there would be some additional continuing administration burden costs introduced because of the additional complexity of two reduced rates, although once the change had fully bedded in it is estimated these would be negligible.

HMRC would incur continuing compliance costs ensuring relief recipients apply the new reduced rate correctly and that they inform their energy suppliers of the changes to their relief entitlement.

Compliance and administration benefits

Detailed and administratively burdensome State aid notifications would not be required since the conditions of State aid simplification would be met. CCA sectors, their sector associations and HMRC would benefit from the savings of the burden of the application procedure for the approval of State aid.

5. Impacts

Results of specific Impact Tests can be found in the annex below.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	Yes
Sustainable Development	No	Yes
Carbon Assessment	Yes	Yes
Other Environment	No	Yes
Health Impact Assessment	No	Yes
Race Equality	No	Yes
Disability Equality	No	Yes
Gender Equality	No	Yes
Human Rights	No	Yes
Rural Proofing	No	Yes

Competition Assessment

The option for change should not have any adverse impacts upon competition as it is not expected to:

- directly limit the number or range of suppliers;
- indirectly limit the number or range of suppliers;
- limit the ability of suppliers to compete; or
- limit suppliers' incentives to compete vigorously.

Small Firms Impact Test

Some small businesses may be affected by the proposals in so far as the transitional compliance costs might represent a slightly higher burden relative to larger businesses as a percentage of their fixed operating costs. However, the CCA arrangements for the smaller businesses should be less complex than those of larger businesses**.** This should mean that less time is spent on the transitional compliance burdens and therefore we would not expect them to incur any material disadvantage implementing this change relative to larger businesses.

Legal Aid

No new criminal sanctions or civil penalties will be introduced as a result of this change.

Sustainable Development

We expect that this change will contribute to the Government's commitment to sustainable development, which consists of five principles:

- living within environmental limits;
- ensuring a strong, healthy and just society;
- achieving a sustainable economy;
- promoting good governance;
- using sound science responsibly.

Carbon Assessment

As a levy on business and public sector energy consumption, CCL delivers carbon savings through its influence on business decisions on the level and composition of energy use. The levy increases the cost of energy use, raises the awareness of the environmental impact, and gives businesses an incentive to seek more efficient and less polluting use of energy.

Independent analysis by Cambridge Econometrics estimates that by 2010 the levy will deliver savings of around 12.8 MtCO2 (million tonnes of carbon dioxide) a year, and CCAs will deliver additional savings of around 7 MtCO2 a year.

The different policy options considered in this document affect the existence and scope of CCAs. In assessing the effects on carbon savings of these options, we have to consider the carbon savings that are expected from two groups of sectors: those subject to the full rates of CCL, and those participating in the CCA scheme and paying the reduced rate.

The preferred option (**Option 1**) is to preserve the CCAs by increasing the reduced rate for all taxable commodities, which will increase the effective CCL tax rates for CCA participants. Three factors can be expected to affect carbon savings under this option.

Firstly, business participation rate in CCAs might drop as a result of the reduced discount rate. This would decrease the number of businesses in CCAs while at the same time increase that under the full rates of CCL. So long as there is a significant difference between carbon savings by businesses under the two regimes, this change in the CCA participation rate would affect total savings. Analysis by DECC suggests that there should be no significant change in the level of participation in CCAs following the proposed change. As such we assume the participation rate will remain largely unchanged.

Secondly, there can be a price effect on energy consumption in the CCA participating sectors due to the proposed rise of the reduced CCL rate from 20 per cent to 35 per cent of the full rates. These businesses facing higher tax rates and higher prices are expected to reduce their consumption accordingly. A model-based simulation incorporating price elasticities to capture the responsiveness of businesses to price changes suggests a reduction in the levels of CO2 emission of about 40 KtCO2 (thousand tonnes of carbon dioxide) a year from 2011-12, or about 200 KtCO2 over five years. Valuing these carbon savings using DECC's recommended carbon prices we have an estimate of about £0.85 million a year or £4 millions over five years in present value.

Thirdly, the setting of energy efficiency targets for CCA participating sectors will affect their carbon savings. Although these targets for the future period are yet to be set by DECC following the current consultations, according to DECC they are not expected to be affected by the proposed change to the reduced rate. Therefore the savings achieved by the CCA sectors meeting these targets also remain unaffected.

A further albeit smaller impact of the preferred option will be a consequential rise in emissions that would occur through the manufacture, distribution and retailing of the paper and envelopes used by relief claimants to notify their suppliers of their new relief entitlement and the Royal Mail's delivery of completed PP11 certificates to the suppliers' premises.

These considerations suggest that the preservation of CCAs with a higher reduced rate in this option would have a positive effect on carbon savings compared with the levels achieved by the current reduced rate. Therefore, by implementing this option, the Government will ensure that the current emissions reductions from the CCA scheme are maintained.

The preferred option is in contrast to the rejected **Option 2**, do nothing, since that option would have the likely consequence of removing the CCA scheme entirely. Carbon savings by facilities in the CCA scheme would be lost under that option since there would no longer be any energy efficiency targets. Affected businesses, mainly energy intensive ones, would incur the full rates of CCL on their energy consumption and would have the incentive to adjust the level and composition of their energy use to achieve a higher efficiency and a lower emission, thus generating carbon savings. These businesses would find the adjustments necessitated by the imposition of the full rates of CCL more costly than the energy efficiency measures required by their participation in the CCA scheme. These higher costs in achieving the emission reduction would have an adverse effect on their competitiveness. The carbon savings achieved under this option would depend on the strength of the price effect on energy demand by these businesses. A simulation exercise indicates that the reduction in emissions could be about 200 KtCO2 per year, or 1 MtCO2 over five years, reflecting their responsive behaviour to the higher rates and energy prices.

The rejected **Option 3** increases the CCL rates for all taxable commodities. With higher rates and hence prices, affected businesses would adjust their consumption level and patterns to a more efficient structure with fewer emissions in order to reduce the cost. This results in a higher level of carbon savings than achieved by the current full and reduced rates: about 500 KtCO2 per year or 2.5 MtCO2 over five years.

The rejected **Option 4**, increasing the reduced rate for gas and solid fuel only, would have an even smaller effect on behaviours than the preferred option. Hence it would not be expected to change carbon saving levels.

Other Environment

The proposal would have little other overall environmental impact although the transitional costs may generate paper waste resulting from the relief certificate process and additional atmospheric emissions from the paper consumption and transport requirements.

Health Impact

The option for change should not have any impacts upon health.

Race Equality, Disability Equality, Gender Equality

The proposed changes would affect businesses and other organisations that claim a CCL reduced rate. There would be no direct impact on individuals. As such, we expect that there would be no impact on gender, race or disability.

Human Rights

The proposed changes are compatible with the European Convention on Human Rights.

Rural proofing

We do not expect that there would be any significant difference to the impact of these proposed changes in rural areas.

Summary: Intervention & Options

Department /Agency: HM Treasury; BIS; HM Revenue and Customs	**Title:** Impact Assessment of the introduction of a “Landline Duty” to help fund the rollout of Next Generation Access (NGA)	
Stage: Final	**Version:** 2	**Date:** 19 March 2010

Related Publications: Implementing a landline duty: consultation on draft legislation and impacts; Digital Britain

Available to view or download at:

http://www.hm-treasury.gov.uk/

Contact for enquiries: Jennifer Gray **Telephone:** 020 7270 6120

What is the problem under consideration? Why is government intervention necessary?

The market is likely to fail to deliver next generation broadband to the *final third* of the UK population due to the higher costs of providing the service. Government intervention is justified on equity grounds: to ensure households and businesses in the final third can benefit from the same range of services as others; and for social inclusion ensuring better access to health and education services that can be provided by super-fast broadband.

What are the policy objectives and the intended effects?

This impact assessment considers the impacts of introducing a new duty to fund next generation broadband. The objective of the new duty is to raise revenue to help fund the roll-out of Next Generation Access (NGA) to 90 per cent of the population by 2017 whilst limiting the administrative costs to business and Government.

What policy options have been considered? Please justify any preferred option.

This impact assessment presents the preferred option to deliver the tax: Network owners will be liable to pay the duty on lines they provide for business or domestic use of phone or data services; lines provided for Social Telephony Schemes will be exempt from the duty. This approach creates the smallest burden for business and Government and removes the potential for the duty to create any competitive distortions.

This final Impact Assessment incorporates evidence provided in response to consultation on the draft legislation and impacts of the duty.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Compliance costs associated with the policy will be reviewed within 3 years of implementation. Progress towards delivering the roll-out of NGA will be reviewed in line with the Digital Britain proposals.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy and, (b) the benefits justify the costs.

Signed by the responsible Minister:

Stephen C. Timms

Date: 19 March 2010

Summary: Analysis & Evidence

Policy Option: 1	Description: Landline Duty: Network Owners liable to pay the duty; lines used under Social Telephony Schemes exempt

COSTS

ANNUAL COSTS		
One-off (Transition)	**Yrs**	Description and scale of **key monetised costs** by 'main affected groups' Network owners and retailers will face one-off costs to familiarise themselves with the new duty. They will also face annual costs associated with meeting HMRC obligations, e.g. provision of information to support their tax payment.
£ 7.5 million		
Average Annual Cost (excluding one-off)		
£ 3,750-11,250	8	**Total Cost** (PV) **£ 7.5 to 7.6 million**

Other **key non-monetised costs** by 'main affected groups' There will be further costs to network owners and to retailers to upgrade software and IT systems. These costs are not included in the above monetised analysis due to their uncertainty. Responses to the consultation appeared to support the original estimate of £30 million, but there was no strong evidence to justify the inclusion of this in the above monetised analysis. HMRC will also face costs to administer the tax.

BENEFITS

ANNUAL BENEFITS		
One-off	**Yrs**	Description and scale of **key monetised benefits** by 'main affected groups' No benefits have been monetised. The duty will generate additional revenue to the exchequer.
£ N/A		
Average Annual Benefit (excluding one-off)		
£ N/A		**Total Benefit** (PV) **£ N/A**

Other **key non-monetised benefits** by 'main affected groups' The benefits of the new duty are associated with helping to fund the rollout of next generation access. These benefits are examined in more detail in a separate BIS consultation, but include increased productivity, opportunities for tele-working, and enhanced delivery of health and education services.

Key Assumptions/Sensitivities/Risks Tax revenues are treated as a transfer and therefore do not score as either a cost or a benefit – the tax is estimated to raise around £175m per year of which around £150m is raised from the duty and £25m is raised from VAT on the duty.

Price Base Year 2009	Time Period Years 8	**Net Benefit Range** (NPV) **£ -7.5 to -7.6 million**	**NET BENEFIT** (NPV Best estimate) **£ -7.55 million**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			1 October 2010	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ negligible	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£	
What is the value of changes in greenhouse gas emissions?			£ reduction	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium £250-750	Large £250-750
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of **£** 3,400-10,225	Decrease of £	**Net Impact**	**£** 3,400-10,225

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

Introduction

1. Digital Britain announced the Government's intention to introduce a new duty on fixed telephone lines to help fund an improved communications network - Next Generation Access (NGA). The announcement suggested a consumer tax on "all fixed copper lines (that is, residential copper lines, the equivalent business analogue and ISDN2 lines and cable telephony lines)".

2. Since this announcement HM Treasury, the Department for Business, Innovation and Skills (BIS), and HM Revenue & Customs (HMRC) have been working closely to develop proposals in more detail. The consultation document "Implementing a landline duty: consultation on draft legislation and impacts" invited comments and feedback on the draft legislation and consultation stage impact assessment.

3. All responses to this consultation have been considered, and are summarised in Government's official response. Although the consultation was clear in its scope, a large number of responses addressed issues that were wholly or partly outside of the consultation. This final impact assessment incorporates the relevant information that was provided. It represents Government's best understanding of the impacts of the landline duty proposals based on consultation responses and engagement with industry and with Ofcom, the independent industry regulator.

4. The information provided in responses has been used to update the estimated familiarisation, administration and compliance costs of the duty. The responses also helped to improve understanding of the impacts to business from the duty. No further evidence was provided to change Government's understanding of other effects of the duty.

Rationale for Government intervention

5. The market is likely to fail to deliver the Government objective of next generation broadband access for 90 per cent of the UK population by 2017. These areas will include rural and remote areas as well as some suburban areas.

6. In these areas, households and businesses will continue to receive broadband services that are relatively slower and less reliable than those in areas able to receive next generation broadband. Such a situation provides a rationale for government intervention on equity grounds:

   - horizontal equity – households (and businesses) in the final third of the population will not be able to benefit from the same range of broadband applications, services and opportunities;

   - social inclusion – households and businesses may be prevented from being able to take advantage of opportunities for greater interaction with the rest of society. For example, they may not be able to tele-work or access improved education and health care services that can be supported by next generation super-fast broadband.

7. Intervention will also support the Government's economic growth objectives, as the improved connectivity offered by NGA is expected to improve productivity for some businesses. This may be especially true for small and medium sized firms that would otherwise be unable to procure a bespoke connection on commercially viable terms. Increased roll-out of NGA should also

improve the UK's international competitiveness, by making the UK a more attractive place to do business.

8. The introduction of this tax will help fund Government spending on the provision of next generation broadband where the market does not deliver. Therefore the new tax plays an important role in tackling these considerations.

Market structure

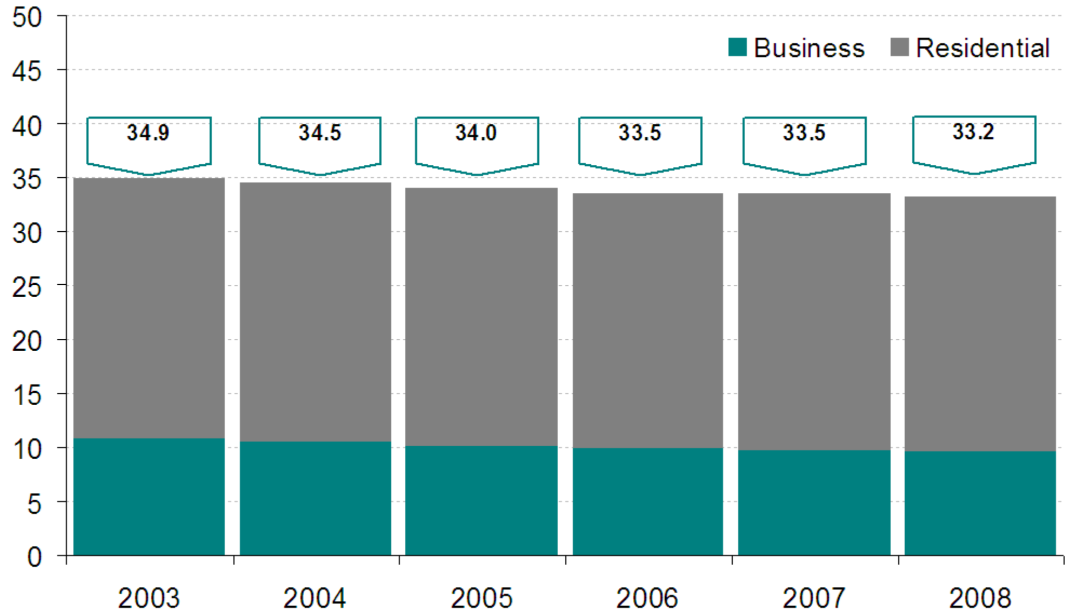
9. This impact assessment uses a simplified approach to describe the market using the terms 'network owners' and 'retailers'. Network owners are businesses that own all or part of a network such as Openreach or Virgin Media. Retailers are businesses that sell services to the end consumer such as BT Retail, Virgin Media, Sky or TalkTalk. In reality there are a number of agents in the market that can act as intermediaries between a network owner and the final retailer.

10. There are important differences between some of the network owners. Openreach is a legacy network owner and is bound by the Universal Service Directive. Openreach sells access to its network to other retailers. This is in contrast to firms like Virgin Media who both own the network and provide consumer access.

Recent trends

11. There has been a very gradual decline in the number of fixed lines in use. This trend can be seen in Chart 1.

Chart 1: Number of fixed residential and business telecoms connections



Source: Ofcom (The Communications Market 2009)

12. Ofcom figures[1] also show that the average bill has fallen by more than 50 pence per month over each of the three years. Since 2005, bills are now £7 per month cheaper on average and this amount exceeds the 50 pence a month level of the new Landline Duty.

[1] Ofcom's Communication Market report, page 242 available at: http://www.ofcom.org.uk/research/cm/cmr09/cmr09.pdf

Provision of Next Generation Access (NGA)

13. The duty does not provide any direct benefits because it represents a transfer to Government. The benefits are derived from how the tax revenue raised is spent. In this case Government has been clear that this new duty is being introduced to help fund the provision of NGA where the market does not. This section describes some of the potential benefits of NGA provision.

Productivity and economic growth

14. NGA will provide benefits similar in type to those that are provided by current generation broadband. These include higher productivity, increased innovation, improved access to new markets and business opportunities created by the growth in e-commerce, greater consumer choice and access to time-saving e-government services[2]. These productivity improvements will help contribute to long run economic growth. Benefits will be assessed in more detail as part of a BIS consultation on the procurement approach to delivering NGA roll-out[3].

Tele-working

15. NGA supported services such as two-way video-conferencing may encourage greater use of tele-working whereby some employees work from home where they can be more productive. This can deliver benefits both to the firm and the worker, as well as the wider economy, society and the environment:

- Help reduce the barriers to entering the labour market for those groups which may be less mobile (e.g. disabled people and single parents with child-care responsibilities who wish to work part-time).

- Potentially contribute to the reduction in traffic congestion as well as carbon emissions improving environmental quality.

- Improve work/life balance (e.g. by reducing the amount of time travelling).

Delivery of health and education services

16. NGA can help improve the quality and delivery of education services to people in more rural and remote areas, helping them become more skilled, productive and earn a higher wage. Australia is an excellent illustrative example of where this is actually happening. According to the Australian Department of Communications, Information Technology and the Arts (DCITA)[4], higher speed broadband has led to the creation of virtual classrooms that help to deliver a better quality of service and enable teachers to engage with students as a group through video conferencing.

17. NGA can also play an important role in improving the quality and delivery of healthcare services. According to DCITA (2007) some health care services can be only be delivered using increasing levels of bandwidth. Therefore NGA could help improve access to medical services and significantly improve health care for people such as the elderly or those living in remote areas.

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[2] These benefits are discussed in greater detail in the impact assessment on the universal commitment for 2Mb/s broadband which formed part of the overall impact assessment for the Digital Britain Final Report published in June 2009. Available at: http://www.culture.gov.uk/images/publications/digitalbritain_impactassessment.pdf

[3] Available online at: http://www.berr.gov.uk/files/file54154.pdf

[4] DCITA (2007) *The economic effects of broadband: an Australian perspective*. This paper can be accessed at: http://www.oecd.org/dataoecd/29/9/38698062.pdf

Social and environmental benefits

18. According to Plum (2008)[5], NGA supported services may help deliver further progress towards the achievement of social objectives such as increased democratic participation, cultural understanding and social inclusion. Furthermore, NGA supported services may make a more powerful contribution to environmental objectives such as carbon abatement and reduced energy consumption[6].

Scope of the tax

19. The new landline duty will be charged on lines that are used to provide telephone or broadband and data services to households and business.

20. Network owners will be liable for the tax and its payment to HMRC. HMRC estimates that there are approximately 15 network-owning businesses that will account for and pay the landline duty to HMRC.

21. We expect these businesses to reflect the duty in the charges they set retail-level service providers for accessing the telecommunications infrastructure. In turn, we then expect retailers to pass the duty through to business and household customers as part of the line rental charge. Around 600 retailers will need to be aware of these potential input price changes in order to reflect it in the line rental charges they set for their business and household customers.

22. The precise amount of duty pass through will ultimately be a commercial decision for network owners and retailers, but for the purposes of the analysis presented in this impact assessment we have assumed 100 per cent pass through to end customers of the £6 a year landline duty for each taxable line[7] (or local loop).

Tax revenues

23. This section covers revenue analysis. It does not make any estimate of deadweight costs[8] that may arise as a result of the duty changing consumers' behaviour to reduce the amount of tax they pay. Given the magnitude of the tax and the very limited amount of substitution expected, this deadweight loss is expected to be small.

24. Taking account of the limited and gradual year-on-year reduction in the number of fixed lines, and a £6 annual charge on all lines delivering voice and/or data services to end users, we estimate revenue from the landline duty will be around £90 million in 2010-11 (assuming the duty is implemented from 1 October 2010) and around £175 million a year thereafter, as set out in 2009 Pre-Budget Report.

25. The revenue projection is based upon the rate of duty plus the value of VAT paid on the duty and takes account of the social telephony exemption. This is consistent with the treatment of all excise taxes (including alcohol and fuel duties) where VAT is payable on the duty itself. The

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[5] A Framework for Evaluating the Value of Next Generation Broadband: A report for the Broadband Stakeholder Group by Plum Consulting, June 2008.
[6] Climate Risk Pty Ltd (2007) *Towards a high bandwidth, low-carbon future.* This report can be accessed at: http://www.climaterisk.com.au/Climate%20Risk%20Telstra_report.pdf
[7] In practice, the actual, or economic, incidence of the landline duty could be borne by retailers in the form of lower profits, or network owners in the form of lower (pre tax) access charges, or business and household end users in the form of higher line rentals. The extent to which costs can be passed on will depend on the market situation of the different firms and the elasticities of demand and supply in each market.
[8] Also known as the 'excess burden' or distortionary cost of taxation. This is the economic loss that society bears as a result of a tax, over and above the amount of revenue it raises.

£175 million projection consists of around £150 million of duty collected and around £25 million of VAT.

26. The revenue projection also factors in a possible behavioural impact from the introduction of the duty on the demand for fixed-line telephony, although this effect is expected to be limited. Research by Ofcom[9] has found that, despite a reduction in the number of fixed lines over time, the use of fixed line voice services has remained relatively resilient in the face of rising mobile telephony take up. Other evidence indicates that fixed and mobile phones are not always viewed as being good substitutes[10], suggesting that many households and businesses will rely on both fixed and mobile communications.

27. In 2009 Q1, 46% of UK households had purchased a bundled communication service such as phone, broadband and TV[11]. The extent to which consumers may decide to avoid the landline duty by switching away from fixed line telephony and broadband to mobile-only communications could also be limited by retailers offering discounts for bundled services, making it relatively more expensive to purchase services separately.

28. At 50 pence per month plus VAT, the duty represents a small increase in the average phone bill. In 2008 the average monthly revenue per fixed telephone line was just under £23[12] and the duty is equivalent to around 2½ per cent of this amount. When internet and/or TV services delivered over fixed lines are also considered, the percentage is even smaller.

Administration and compliance costs

29. Compliance costs are made up of a number of components:

- One-off costs to business arising from the introduction of the landline duty (e.g. time spent becoming familiar with the tax).
- Continuing costs of complying with the duty's obligations or the "administration burden". This includes providing information to HMRC to calculate or verify the amount of duty due, filing tax returns and record keeping requirements.

30. The estimates in this section have been revised to incorporate information provided in response to the consultation. Only a small number of firms provided additional information and occasionally it has not been possible to incorporate this into new cost estimates. This could be due to information not being representative of the industry as a whole or where publishing an estimate could not be done without revealing commercially sensitive information from responses.

One-off costs

31. The one-off costs of the landline duty will include familiarisation with the new tax and systems development by network-owning businesses so that they can correctly account for and pay the duty to HMRC. The retailers may also require systems changes and incur re-pricing costs.

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[9] *The Communications Market 2008,* Ofcom (page 295)
[10] Ofcom (2009) *Fixed Narrowband Retail Services Market: Consultation on the identification of markets and determination of market power* http://www.ofcom.org.uk/consult/condocs/retail_markets/fnrsm_condoc.pdf
[11] Ofcom research, 2009Q1
[12] *The Communications Market 2009*, Ofcom

Familiarisation

32. Familiarisation refers to the time telecommunications businesses will need to spend to understand the new landline duty and how it affects them. Based on the evidence supplied in the consultation, total costs of familiarisation are estimated to be £7.5 million for the industry (network owners and retailers).

Systems development and changes

33. Network owners will need to ensure that their IT systems can correctly account for the duty on each taxable line to allow them to file an annual return and pay the duty to HMRC. It is anticipated that this system development will build in large part upon existing IT infrastructure used to monitor the lines leased to retailers. A software upgrade to an existing system is likely to be all that is needed, but a higher cost bespoke system or 'bolt on' may be required.

34. Retailers are also likely to need to make some changes to their systems to accommodate the landline duty. The main change will be the need to identify and report the number of exempt lines for audit purposes, and to ensure that these lines are not taxed. This burden will only fall on BT and KCOM, as they are the only current providers of social telephony schemes.

35. Some retailers may decide to include the duty as part of the line rental or overall package charge to customers, while others may choose to add it as a separate explicit item on the bill. This would likely incur some costs to change the format of the bills. However, it will not be mandatory to show the duty as a separate line on bills to end users and any decision by retailers to do so would be an entirely commercial one.

36. System development costs were estimated to be £30 million in the consultation stage impact assessment. Several responses provided estimates of IT development costs but these varied significantly and so did not allow for the calculation of a more robust estimate.

Re-pricing

37. The duty may require the revision of business plans for network owners and retailers as they consider whether and how to pass the duty on and what changes any published material may be required. This would give rise to 'menu costs', the costs to business of changing prices (in this case to factor in the 50 pence monthly charge per line).

38. Telecommunications retailers change prices on a regular basis and we expect that in most cases the changes will be built into existing re-pricing rounds (and so will not represent an additional unplanned cost). The Digital Britain report announced the broad scope and rate of the duty with a commitment to introduce it in the 2010 financial year, giving telecommunications businesses time to plan for the changes. This implementation will take place in October 2010 to coincide with existing re-pricing schedules.

39. Responses to the consultation provided only very limited evidence about re-pricing. The information provided was very firm specific and therefore not representative for all the network owners and retailers with the sector. This means it has not been possible to quantify these costs but it is expected that most costs will be a one-off and to some extent may be included in the system change costs above. Future re-pricing activity is likely to be absorbed into existing mechanisms and therefore have a minimal cost.

On-going costs

40. For existing taxes, HMRC uses a model known as the 'Standard Cost Model' (SCM) to estimate the ongoing costs (administration burden) to business of complying with HMRC obligations.

41. The SCM considers which activities a business has to do to comply with an HMRC obligation, how many businesses have to comply, and how often they need to do so. The SCM considers the burdens applying to different sizes of business. It also estimates the costs of using agents, the costs of undertaking work in-house and the costs of actually transmitting the information (e.g. sending in a tax return)[13].

42. The main administration burden of the duty will be the requirement for network owners to submit an annual return to HMRC detailing the number of taxable lines supplied in the previous year together with payment.

43. Using an illustrative range of 10-30 hours for the average time taken for each business to compile, check and file an annual duty return at an hourly wage rate of £25 gives an indicative estimate of the administration burden per network-owning business of around £250-750. Assuming 15 network-owning businesses, this gives an indicative total annual cost of £3,750 - £11,250. The illustrative range has been increased to 10-30 hours from 10-20 hours in the consultation stage IA to reflect information provided in the consultation process.

44. There may also be a further administrative burden where retailers have collected and retained information about the number of social telephony scheme services they offer. The retailer will then have to pass this information to the network owner in order to ensure that these schemes are exempt. Our current understanding is that only BT and KCOM will face these costs, as they are the only current providers of these schemes.

HMRC costs

45. HMRC will need to develop its own systems to administer the landline duty, including registering taxpayers, issuing returns, receiving payments and undertaking compliance activities. HMRC will bear additional resource costs, including:
    - some staff-training costs as this is will be a new system;
    - publicising of the requirements to businesses;
    - production of tailored guidance;
    - collating data from returns;
    - dealing with queries from businesses on the new requirements; and
    - dealing with incorrect claims within the stipulated timescales.

46. These costs have not been quantified but it is expected that the majority of resource costs will be on a one-off basis. The customer relationship management model that HMRC uses in fostering a closer working relationship with taxpayers means that additional on-going costs are expected to be minimal and will quickly form a routine part of HMRC activity.

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[13] The SCM does not consider one-off costs or transitional costs which are discussed above. Nor does it consider costs which a business would have incurred anyway had the relevant HMRC obligation not existed. It considers the costs which apply to a normally efficient and compliant business. The SCM does not consider wider compliance costs, such as business uncertainty, cash flow costs, or the costs of deciding whether or not to do something. SCM figures in impact assessments are presented in May 2005 prices, as admin burden reduction targets relate to a May 2005 baseline. The figures are also uplifted to current day prices.

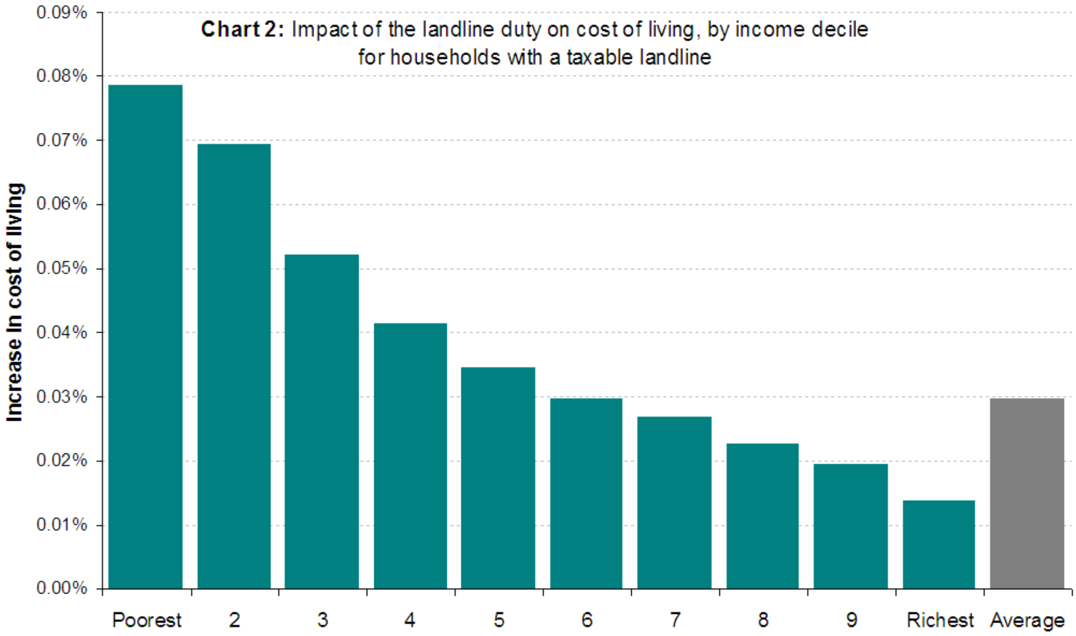
Distributional analysis

Impacts on households

47. We expect the duty to be passed through to household and business customers in the form of higher line rental charges. As a fixed charge for each taxable line, the financial impact of the duty could be relatively greater for lower income households with landlines compared with higher income households, although this will depend on how retailers decide to pass on the charge across different customer groups.

Cost of living

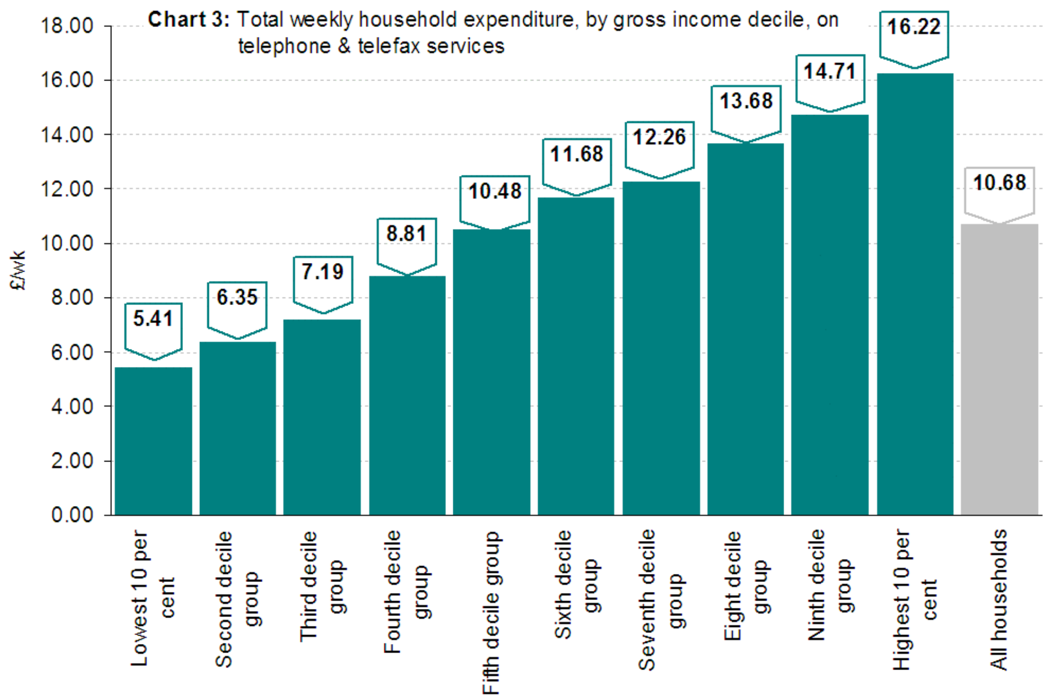
48. Chart 2 shows a simulation of the possible increase in the cost of living as a result of the landline duty by income decile. The simulation assumes one taxable landline per household and that all other household expenditure remains unchanged. It shows that the cost of living will tend to increase most for lower income households with a landline, but even here the increase is less than 0.1%.



Source: Calculations from 2007 Expenditure & Food Survey

Expenditure

49. Chart 3 shows average weekly household expenditure on landline and mobile telephone services by income decile.



Source: ONS - Table A8, pg. 98, Annex A, Family Spending: 2008 Edition

50. Using this data, the duty represents just over 1 per cent of average total expenditure on telephone and telefax services across all households (internet spending is not included). The proportionate impact of the duty is lowest for higher income groups, at less than 1 per cent of spending on telephone and telefax services in the top income decile compared with 2½ per cent of spending in the bottom decile.

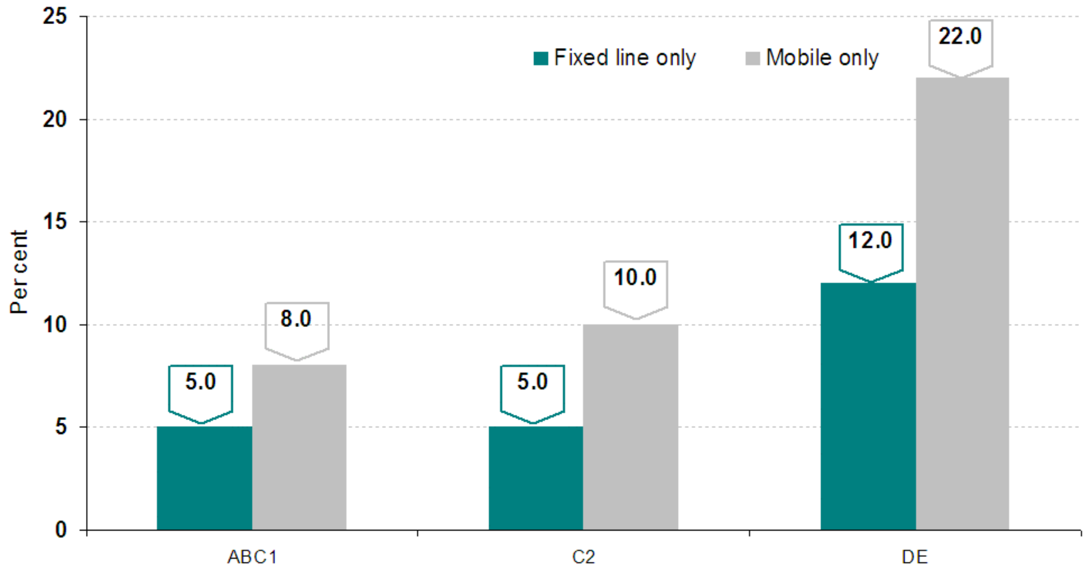
51. Alternative data based upon information from Ofcom, operators and the ONS suggests that in 2008 households spend £65.01 on average on telecommunication services per month. This alternative data includes internet and broadband spending but is broadly consistent with evidence from Family Spending. The alternative data suggests that as a proportion of expenditure the new duty is even lower than 1 per cent.

52. The impact of the duty on low income households will be mitigated:

- There is an exemption from the duty for households with social telephony tariffs that are available to those on certain means tested benefits including: Income Support; Income-based Jobseeker's allowance; Pension Credit (Guaranteed Credit); Employment and Support Allowance (income related). Approximately 850,000 households have a social telephony tariff and around a further 3-4 million are eligible for one.

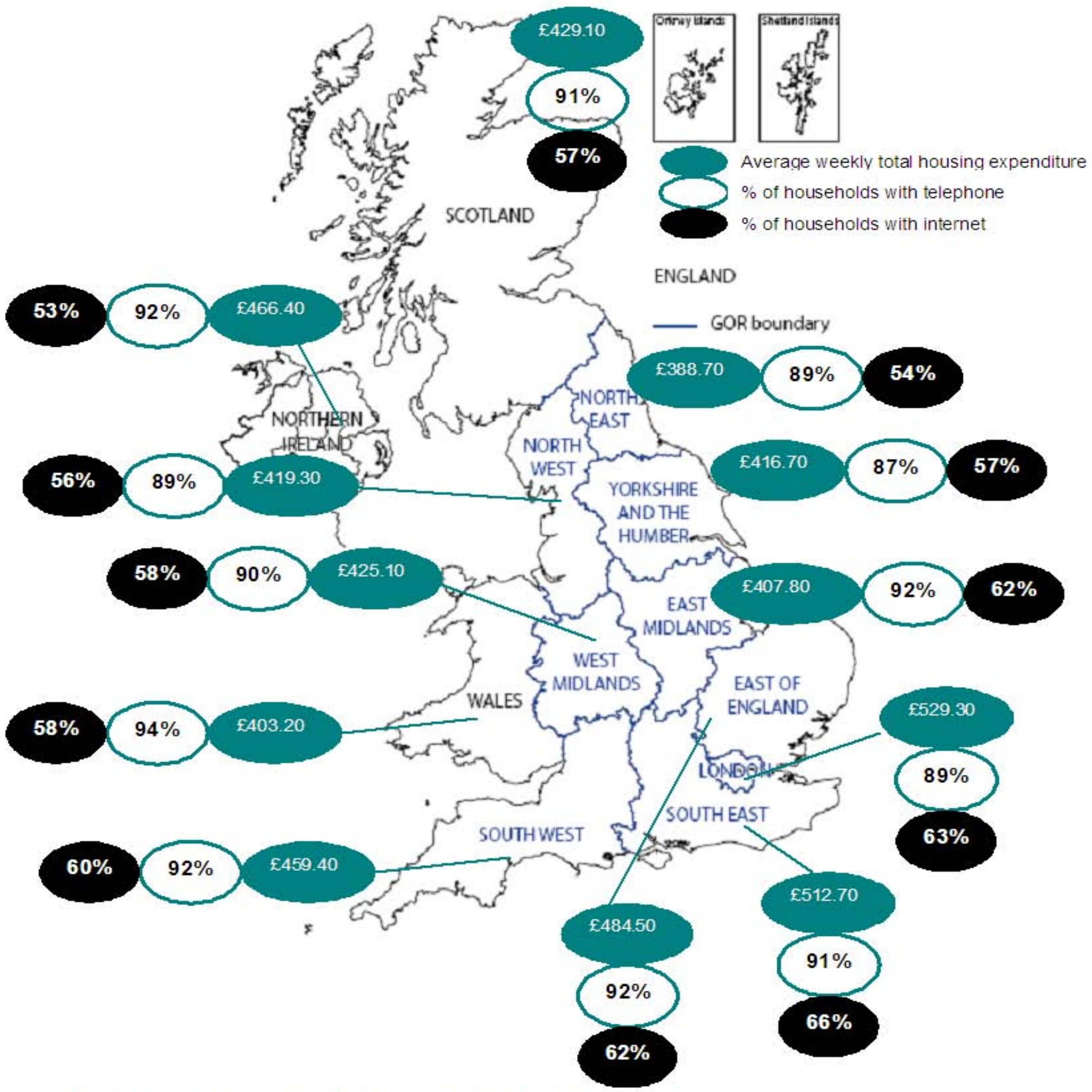
- A greater proportion of low income households and those in socio economic groups C2, D and E do not have a landline and instead use mobile phones as their sole means of communication, as shown in Chart 4. These households will not be directly affected by the landline duty.

Chart 4: Type of household telcom connection by socio-economic group



53. Chart 5 shows average weekly household expenditure by region and the proportion of households in each region who have telephone and internet access. In proportionate terms, the duty will tend to have the largest impact on the cost of living in regions where average household spending is lower (for those households with a taxable landline), but as discussed above, the overall effect is small.

Chart 5: Average total weekly household spending, percentage of households with telephone and internet



Source: ONS – Table A53, pg. 170, Annex A, Family Spending: 2008 Edition
Table A37, pg. 156, Annex A, Family Spending: 2008 Edition

Impacts on business

54. There is likely to be a positive but imperfect relationship between the amount of duty paid and the size of the business in terms of number of employees. We expect that in general larger firms will have a higher exposure to the new duty than smaller ones.

55. For the majority of firms, we would expect the financial impact of the duty to be fairly small in relative terms:

- Small firms with comparatively few employees may have a small number of copper lines but alternatively could have one or two fibre lines which would limit their potential exposure to £1 per month.
- Medium size firms could use a number of ISDN8 or ISDN30 lines at their offices or may have a bespoke solution negotiated directly with the retailer. Again it is unlikely that any office would have a substantial number of lines as it becomes more cost effective to have a bespoke solution than large multiples of ISDN lines.

- Large firms usually have bespoke telecommunication solutions, which would typically be delivered by a small number of high capacity fibre lines. They are likely also to have a number of copper lines, e.g. for fire alarms or as a contingency, and will be exposed to the duty via these lines as well as through their fibre connections.

Competition Assessment

56. The introduction of the new duty could have an impact on competition in the market. There are two main areas where the tax could have an impact on competition: competition between fixed line and mobile operators; and competition between different fixed line retailers.

Competition between mobile and fixed line operators

57. As explained in the tax revenue section above we do not believe that there will be a significant substitution effect between use of fixed and mobile communications. The evidence for this includes:
    - Ofcom research showing fixed line voice services have remained resilient to rising mobile take up;
    - the bundled nature of many services received by consumers meaning a fixed line forms part of a telephone, television and broadband package;
    - the limited scope for mobile broadband to deliver a comparable level of speed and service as fixed broadband in the time for which the tax is planned to be in force; and
    - the small level of the new duty compared with levels of household and business expenditure on communications.

Household consumers

58. Ofcom research[14] has shown that non-price factors can have considerable weight in consumer choice. There are a number of consumers who value the simple and consistent nature of fixed telecoms very highly and are unlikely to be influenced by price factors. This is particularly the case in areas where mobile coverage is more limited.

59. The importance of non-price factors is particularly relevant for broadband services. Broadband users, particularly heavy users, are likely to be dependent on a fixed service for the proposed duration of the tax to access high speed, high volume services. Mobile broadband is currently viewed in the industry as a complement to, rather than a substitute for, fixed broadband[15].

60. The duty has also been designed to include broadband services to address concerns that phone users may substitute to voice over internet protocol (VOIP) services such as Skype. This design means that users that choose not to take a phone service will still pay the duty. This removes a potential source of market distortion because the relative prices of fixed telephone and VOIP will remain as they currently stand.

61. Low-income users might be expected to be the most price sensitive but the new duty is unlikely to introduce a market distortion for these consumers. These users often choose to use mobile connections only or are eligible for social telephony schemes. Neither of these options attracts the duty and so the consumer choice would be indifferent to the current situation.

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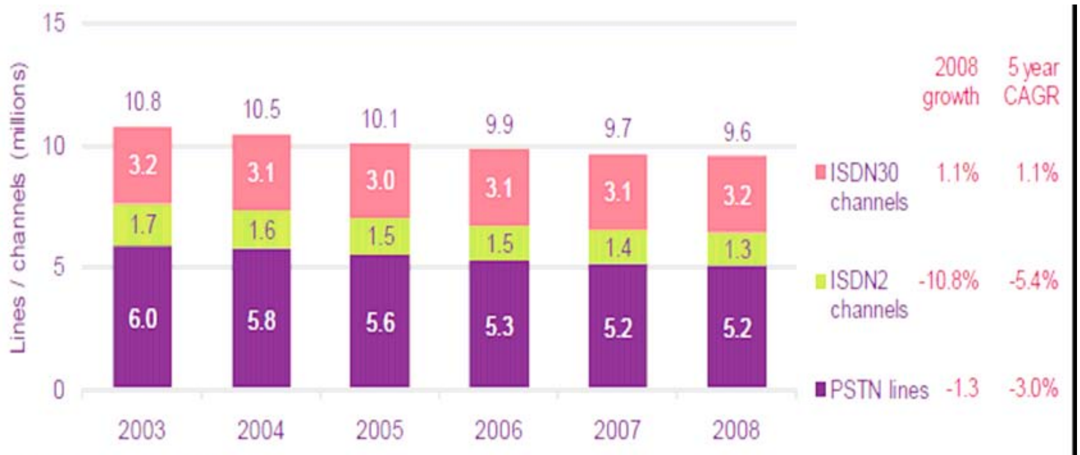
[14] Ofcom (2009) *Fixed Narrowband Retail Services Markets: Consultation on the identification of markets and determination of market power* http://www.ofcom.org.uk/consult/condocs/retail_markets/fnrsm_condoc.pdf, para 4.30
[15] http://www.guardian.co.uk/business/2009/oct/08/dongles-wifi-broadband-smartphones

Business users

62. There is some evidence that businesses are making an increasing proportion of calls by mobile rather than using fixed telephony. The volume of mobile calls as a percentage of total calls has increased significantly since 2005. This has been driven by the increased functionality and speeds offered by mobile phones.

63. However, even with an increasing number of calls being made by mobile, the number of fixed business lines remains broadly constant, falling by only 1.8% in 2008. Figure 6 below shows this reluctance to give up fixed lines, and suggests that few would be given up with the introduction of the tax; many businesses consider fixed lines vital for keeping in contact with clients, suppliers and customers[16].

Figure 6: Business fixed lines, by type (millions)



Source: Ofcom / operators
Note: Figures may be overstated due to an element of double-counting of WLR lines

Competition between different fixed line retailers

64. The new duty could impact on competition between different fixed line retailers if for some reason it gave one network owner, retailer or product a distinct advantage over another. However, we do not believe this to be the case.

65. The current telecommunications market is very competitive with retailers striving to offer the best deals to customers. Given this high level of competition, retailers already pass any potential cost savings through to consumers and are not in a position to make supernormal profits.

66. The duty has also been designed to ensure that customers who receive a phone service from one operator but choose to purchase broadband from another will only pay the duty once if they have just one line (assuming the duty is passed through to consumers). This is an important measure to ensure that the incumbent provider of the telephone service does not have any advantage over their competitors.

67. The way telecommunication services are provided in bundles and that consumers choose based upon these bundles suggests that the impact of the duty will be minimal. Telephone and broadband services are often provided together from a single retailer; other services such as television packages are often included as well. The choice of bundle can often be driven by the

[16] Ofcom (2009) Communications Market Report.

availability of certain television packages suggesting the duty will have no impact on competition between providers.

68. There may be some differences in the level of administration costs faced. Openreach, as the largest network owner and with the highest number of retailers leasing lines, is likely to face the largest costs. However, Openreach is in a unique situation as the regulated legacy network owner and does not directly compete with other network owners in a number of areas. We are content that their costs are not disproportionate.

69. Different retailers are also likely to face different costs in amending their systems for billing purposes. Initial discussions with industry suggested that these costs could be minimised by the new duty being included in the fixed line rental part of billing and the tax being introduced at a point when firms would normally make billing changes. The tax has been designed to allow this to limit costs to retailers and therefore the potential for any distortion in the market.

Small firms impact test

70. The vast majority of firms are small firms employing fewer than 20 or fewer full time equivalent staff, most of which are sole proprietorships or partnerships with no employees. It can therefore be reasonably assumed that the financial impact of the proposed duty on these businesses is likely to be small given that they are unlikely to have very many fixed lines.

Other specific impact tests

71. Specific tests including the Small Firms Impact Test, Legal Aid, Sustainable Development, Carbon Assessment, Other Environment, Health Impact Assessment and Rural Proofing have been considered in this impact assessment. After initial screening, it has been deemed that no significant impact is anticipated in any case.

72. We have also considered the potential effects of these proposals on race, disability, gender equality and on human rights. Again, after initial screening it has been deemed that no significant impact is anticipated in any case.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency: HM Treasury	**Title: Salary Sacrifice: Restricting the tax exemption for workplace canteens**	
Stage: Implementation	**Version:** Final	**Date:** 16 February 2010
Related Publications: None		

Available to view or download at:

http://www.hmrc.gov.uk/better-regulation/ia.htm

Contact for enquiries: **David McDowell (HMRC)** **Telephone:** **020 7147 0175**

What is the problem under consideration? Why is government intervention necessary?

There is an exemption from tax under the employment income rules whereby an employer can provide the benefit of free or subsidised meals in a canteen or on its business premises, subject to certain conditions. The Government has become aware that some employers and employees have developed remuneration arrangements involving salary sacrifice or flexible benefits to take advantage of this exemption. These arrangements are intended to allow some employees to purchase meals out of gross pay, and hence obtain a significant tax and National Insurance Contribution (NICs) advantage over the majority of employees who must purchase their meals using their net pay, from which tax and NICs have already been deducted.

What are the policy objectives and the intended effects?

The Government wishes to address the problem outlined above by removing the exemption for the benefit of employer-provided free or subsidised meals where an employee has an entitlement to such meals in conjunction with salary sacrifice or flexible benefits arrangements. In this way the policy has been targeted to affect only those arrangements where a significant tax and NICs advantage is gained by the employer and employee. The Government intends that employers will either withdraw the affected arrangements or apply tax and NICs to the benefit provided where the arrangements remain in place.

What policy options have been considered? Please justify any preferred option.

Aside from the policy described, the only other option considered was to leave the exemption untouched. This was rejected because maintaining the status quo would have allowed the unfairness described above to continue and represented a risk of growing cost to the Exchequer.

The policy announced at the 2009 Pre-Budget Report will not be implemented until 2011 to allow employers and employees with effective existing arrangements time to adjust. The solution is carefully targeted so that other arrangements will not be affected and the exemption will continue to apply in relation to general subsidies for canteens that are available to all employees.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

This policy was announced in the 2009 Pre-Budget Report and will be implemented from 6 April 2011. The Government will review the impact of the policy when data becomes available.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Stephen Timms Date: 16/02/2010

Summary: Analysis & Evidence

Policy Option: 1	**Description: Removing the exemption for free or subsidised meals where the employee has an entitlement in conjunction with salary sacrifice or flexible benefits arrangements**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'	
One-off (Transition)	**Yrs**	Administrative costs of familiarisation with requirement to tax this benefit and of completing additional P11D forms or adding further information to existing P11D forms. Additional cost of revising employment contracts for employees whose existing arrangements are withdrawn.	
£210,000			
Average Annual Cost (excluding one-off)			
£520,000		**Total Cost** (PV)	**£ 2.5 million**

Other **key non-monetised costs** by 'main affected groups'

None

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'	
One-off	**Yrs**	None	
£ 0			
Average Annual Benefit (excluding one-off)			
£ 0		**Total Benefit** (PV)	**£ 0**

Other **key non-monetised benefits** by 'main affected groups'

Possible benefit to employers that withdraw existing arrangements if it removes the need to track employees' canteen expenditure at point-of-sale. Benefit for taxpayers of greater fairness in the tax system.

Key Assumptions/Sensitivities/Risks

50% of affected employees receive cash remuneration instead of the canteen benefit. Of remaining 50% of employees who continue to receive this benefit, 80% already receive benefits that necessitate the completion of a P11D form. Exchequer yield is estimated to be £110m per annum from 2011/12.

Price Base Year: **2010**	Time Period Years: **5**	**Net Benefit Range** (NPV) **£ 0**	**NET BENEFIT** (NPV Best estimate) **£ 0**

What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	6 April 2011			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	Not known			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	Yes			
What is the value of the proposed offsetting measure per year?	£ 0			
What is the value of changes in greenhouse gas emissions?	£ 0			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large ~£2,000
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £450,000 Decrease of £ 0 **Net Impact** **£ 450,000**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Background

Under the employment income rules benefits in kind provided by an employer to an employee are normally liable to income tax and NICs. However there is an exemption from the employment income rules whereby an employer can provide the benefit of free or subsidised meals in a canteen or on its business premises free of tax, subject to the condition that:

- the meals are reasonable in scale;
- free or subsidised meals (or a voucher for such meals) are available to all the employer's employees at the relevant location; and
- in the case of a hotel, catering or similar business, if free or subsidised meals are provided for employees in a restaurant or dining room when meals are being served to the public, part of the dining area must be designated for staff use only and the meals must be taken in that part.

This exemption allows employees to benefit from canteen arrangements provided by their employer without incurring a tax liability, for example a general subsidy reflected in canteen prices being lower than typical commercial prices. It also serves to remove any burden for employers who would otherwise have to calculate and attribute the benefit provided to specific employees.

The Government is aware that some employers and employees have developed remuneration arrangements involving salary sacrifice or flexible benefits to take advantage of this exemption.

In salary sacrifice arrangements the employee agrees to reduce their existing taxable employment income in return for being provided with food and drink in the workplace canteen commensurate with the amount of income they have given up.

In flexible benefit arrangements the employee agrees a total annual employment reward that provides for some flexibility in the composition of the package. This will typically be a fixed amount of cash pay with the balance of the package's value being made up of one or more benefits, which in this instance would include provision of canteen meals, commensurate in value with the related amount of income in the package.

Under both types of arrangement the employee explicitly receives the tax-exempt canteen benefit instead of other forms of employment income liable to tax and NICs. This is intended to allow the affected employees to purchase meals out of gross pay and hence obtain a significant tax and NICs advantage over the majority of employees who must purchase their meals using their net pay, from which tax and NICs has already been deducted. In addition, employees using such arrangements receive a double tax relief in the sense that the refreshments they purchase out of their gross income are necessarily already subsidised by the employer (because free or subsidised meals must be available to all employees for the exemption to apply), and that subsidy is exempt from tax.

Rationale for Government Intervention

Fairness

Salary sacrifice and flexible benefit arrangements for workplace canteens have become increasingly common since 2007. As outlined above, employees who subscribe to such arrangements gain a significant tax and NICs advantage. This is unfair to those employees who do not participate in these arrangements and the Government has concluded that there is no justification for allowing some employees to continue to derive a tax and NICs advantage in this way.

The Government does, though, recognise that the underlying exemption serves a legitimate purpose when not used in conjunction with such arrangements, for example where a general subsidy is provided that is available to all employees. Accordingly, the exemption will continue to apply in those circumstances.

Exchequer cost

These arrangements represent a growing cost to the Exchequer as employees and employers use them to reduce their tax and NICs liability.

Policy objective

The Government wishes to address the problem outlined above by removing the exemption for the benefit of employer-provided free or subsidised meals where an employee has an entitlement to such meals in conjunction with salary sacrifice or flexible benefits arrangements. In this way the policy has been targeted to affect only those arrangements where a significant tax and NICs advantage is gained by the employer and employee. The Government intends that employers will either withdraw the affected arrangements or apply tax and NICs to the benefit provided where the arrangements remain in place.

Estimates of population and Exchequer cost

Her Majesty's Revenue and Customs (HMRC) does not generally hold data about the number of people benefiting from specific tax exemptions because, by definition, there is no requirement for the employee or employee to declare any information. Therefore, data from research carried out by EmployeeBenefits.co.uk ("The Benefits Book 2009") and the Department for Business Innovation and Skills' "Small and Medium Enterprise Statistics for the UK and Regions" has been used. From this data it is estimated that 280,000 employees currently subscribe to workplace canteen arrangements using salary sacrifice or flexible benefits and so will be affected by this policy. It is further estimated that 250 employers will be affected and it has been assumed for this analysis that all employers will be large companies with more than 500 employees.

It is estimated that existing salary sacrifice and flexible benefit arrangements for this benefit cost the Exchequer £125m per year. This cost is derived by assuming an average amount of cash salary sacrificed by employees participating in the arrangements, then multiplying this by the number of employees and applying an average tax and NICs rate. It is assumed that the theoretical yield from removing the tax exemption for such arrangements will be reduced slightly as a result of some employers providing an increased subsidy or free meals for all employees, funded by suppression of cash salary for all. However, it is thought this will be a relatively rare occurrence. No other behavioural change or avoidance has been assumed.

<u>Policy options</u>

Option 1:

Description

Remove the tax exemption for the benefit of free or subsidised meals where provided in conjunction with salary sacrifice or flexible benefits arrangements.

Risks

No significant risks are envisaged. The policy has been closely targeted to affect only those employees who receive a canteen benefit under the arrangements described above and so there is no risk of unintentionally affecting all employees who receive a canteen benefit or placing a significant burden on employers by forcing them to calculate the value of the benefit for all employees. The policy will not be implemented until 6 April 2011 and this will give employers and employees with effective existing arrangements sufficient time to make necessary adjustments, thereby minimising any administrative costs. It is not expected that the policy will affect employment patterns or materially increase the cost of employing those who currently use these arrangements.

There is no significant risk of behavioural change or of employers or employees switching to similar arrangements to reproduce the same tax and NICs advantage.

Costs and Benefits

One-off costs

In the case of employees retaining effective salary sacrifice or flexible benefit arrangements after the exemption becomes taxable, the extra obligation placed on employers is one that they are already familiar with, namely the completion of P11D benefits and expenses forms. Therefore, the transitional costs are merely those of recognising that new legislation is in place and changing procedure. If this process were to take 2 hours per firm, given the estimate of around 250 firms participating in these schemes in total, 50% of employers retaining existing arrangements and an hourly wage rate of £20 in line with the Standard Cost Model, this one-off cost is unlikely to be more than £5,000 in total.

Where employers choose to withdraw existing arrangements there will be a one-off cost associated with revising the affected employees' contracts of employment (which specify whether salary sacrifice or flexible benefit arrangements are in place). It is assumed that existing arrangements will be withdrawn for 50% of affected employees and hence that, assuming it takes 5 minutes to revise each employee's contract and a wage rate of £15.13 for "personnel officers" from the Standard Cost Model, the cost will be £175,000 in total.

The combined total of these one-off costs is therefore estimated to be £180,000 in 2005 prices. This translates to £210,000 in 2010 prices.

Continuing costs

To evaluate the continuing administrative burden placed on businesses the Standard Cost Model is used. The model uses an activity-based costing methodology to quantify the cost to businesses of complying with HMRC obligations.

It is assumed that the estimated 280,000 employees affected by this policy are employed by large firms and that employers will withdraw salary sacrifice or flexible benefit arrangements schemes for 50% of affected employees (140,000) as a result of the policy. Employers of these 140,000 employees will face no ongoing cost. This leaves 140,000 employees retaining the existing arrangements, of whom it is assumed 80% already receive other benefits in kind and so receive a P11D benefit and expense form. All ongoing cost is related to the completion of P11D forms. The basis for calculating a cost per form depends on the activities that an employer undertakes to complete forms. Using this, it is calculated to take approximately 20 minutes to complete a new form (i.e. where the employer does not already complete a P11D form for an affected employee) and 8 minutes for an existing form (i.e. where the employer would only need to make an adjustment to an existing P11D form for an affected employee). These figures are then applied to the £18.20 weighted average wage rate associated with large firms complying with the obligation and multiplied by the number of employees affected to calculate the burden from the policy. Based on these assumptions, the total ongoing administrative cost placed on employers is estimated at £450,000 in 2005 prices. This translates to £520,000 in 2010 prices.

Benefits

None quantified. It is possible there will be a benefit to employers that withdraw existing arrangements as it would remove the need to track employees' canteen expenditure at point-of-sale.

Option 2:

Description

Leave the tax exemption for workplace canteens in place where it is provided in conjunction with salary sacrifice or flexible benefit arrangements.

Risks

The Exchequer would continue to lose tax and NICs revenue. Approaches to HMRC from prospective scheme providers and HMRC compliance activity indicate that the use of these arrangements has been growing. Unless action is taken there would be a risk of continued growth in the number of employers and employees participating and hence Exchequer loss. This would also entrench and extend the unfairness that results to employees who receive workplace canteen refreshments but do not participate in these arrangements.

Small Firms Impact Test

The Government believes that salary sacrifice and flexible benefit arrangements for workplace canteens are most prevalent amongst large employers. The impact of this measure on small businesses is considered to be negligible.

Competition Assessment

Salary sacrifice and flexible benefit arrangements are typically offered to employers by third-party providers and advisors. This policy might indirectly limit the number of such providers if the result were a substantial drop in demand for one of their products. However, it is unlikely that any of these providers offer workplace canteen arrangements as their sole or main product and so this policy will not place them at a competitive disadvantage. In addition, this is not considered to be a competition effect because these providers are exploiting a tax exemption beyond its original intention. It is not expected that the policy will have a negative competitive effect on employers that currently offer these arrangements or on the sectors in which these employers operate.

Other specific impact tests

In line with best practice the Government has considered the remaining impact tests and does not think the policy will have an impact on rural areas, gender or race equality, human rights, health, legal aid, sustainable development, other environment or carbon assessment.

Specific Impact Tests: Checklist

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Annexes

The Standard Cost Model

The 'Standard Cost Model' (SCM) has been used to derive an estimate of the costs to business of complying with HMRC obligations to disclose information to HMRC or to third parties. The SCM considers which activities a business has to do to comply with an HMRC obligation, how many businesses have to comply, and how often they need to comply. The SCM considers the burdens applying to different sizes of business.

The SCM estimates the costs of using agents; the costs of undertaking work in-house; and the costs of actually transmitting the information. The SCM does not consider one-off costs or transitional costs. The SCM does not consider costs which a business would have incurred anyway had the relevant HMRC obligation not existed. It considers the costs which apply to a normally efficient business and the costs to businesses which comply. The SCM does not consider wider compliance cost issues, such as the costs of business uncertainty, cash flow costs, or the costs of deciding whether or not to do something.

The Impact Assessment template requires SCM figures to be presented in May 2005 prices, as admin burden reduction targets relate to a May 2005 baseline. The Impact Assessment also uplifts those figures to current day prices.

Summary: Intervention & Options

Department /Agency:	Title:	
HM Revenue & Customs	**Impact Assessment of Strengthening and Revising the Disclosure of Tax Avoidance Schemes (DOTAS) regime**	
Stage: Implementation	**Version:** 1.0	**Date: 15 March 2010**

Related Publications: The consultation "Disclosure of Tax Avoidance Schemes (DOTAS)" published on 9 December 2009 and the Summary of Responses to that consultation.

Available to view or download at:

http://www.hmrc.gov.uk/consultations/

Contact for enquiries: Philippa Staples **Telephone:** 020 7147 2444

What is the problem under consideration? Why is government intervention necessary?

The Disclosure of Tax Avoidance Schemes (DOTAS) regime was introduced in 2004 and has provided HMRC with early information about tax avoidance schemes, informing 49 Pre Budget Report (PBR)/Budget measures, up to and including PBR 2009, that have closed off over £12 billion in tax avoidance opportunities. It has also informed HMRC's compliance work.

HMRC has identified a number of areas of DOTAS that are either being exploited by a small number of promoters or where it could be improved. The Government proposes to remove these weaknesses in order to further bear down upon tax avoidance.

What are the policy objectives and the intended effects?

The objectives are to:

(a) improve and speed up the information that HMRC receives about tax avoidance schemes to inform risk assessment and the selection and timing of anti-avoidance legislation;

(b) improve the identification of users of tax avoidance schemes, so informing HMRC's selection and management of schemes and returns for enquiries; and

(c) affect the economics of avoidance.

What policy options have been considered? Please justify any preferred option.

1. Do nothing.

2. Revise and extend DOTAS in a package of measures.

Option 2 is the preferred option.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Expected three years from the date that the legislation implementing the package comes into force.

Ministerial Sign-off For Implementation Impact Assessment:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the cost.

Signed by the responsible Minister:

Stephen C. Timms

Date: 15 March 2010

Summary: Analysis & Evidence

Policy Option: 2	Description: A package of measures to revise and extend DOTAS

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' One off IT cost to HMRC of providing for client lists. Admin costs for promoters and some taxpayers of training staff and introducing new reporting processes.	
One-off (Transition)	**Yrs**		
£ 250,000	1		
Average Annual Cost (excluding one-off)			
£ 275,000	5	**Total Cost** (PV)	**£ 1.1million**

Other **key non-monetised costs** by 'main affected groups' Costs to HMRC, promoters and some taxpayers of becoming familiar with the new rules. Potential increased costs in imposing penalties if a higher penalty leads to a greater degree of litigation.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' The benefit is captured on the estimated exchequer effect (see Key Assumptions/Sensitivities/Risks) and it is not reported in this section. It includes enhancing government's ability to introduce timely anti-avoidance legislation and target compliance resources more effectively.	
One-off	**Yrs**		
£ n/a	n/a		
Average Annual Benefit (excluding one-off)			
£ n/a	n/a	**Total Benefit** (PV)	**£ n/a**

Other **key non-monetised benefits** by 'main affected groups' Greater certainty to promoters about what schemes to disclose and when. Reduced HMRC and customer admin costs resulting from a more targeted approach to anti-avoidance legislation and compliance work. Reduced HMRC admin costs resulting from more effective prioritisation of resources.

Key Assumptions/Sensitivities/Risks Targeting of the new rules at significant avoidance risks will reduce the the risks of onerous, unnecessary and unwanted disclosures. Increased yield from improved detection is estimated to be in the region of £25m for 2010/11 and £50m per year thereafter. We also estimate that the measures will protect revenue in the region of £200m per year.

Price Base Year 2010	Time Period Years 5	**Net Benefit Range** (NPV) **£n/a**	**NET BENEFIT** (NPV Best estimate) **£ n/a**

What is the geographic coverage of the policy/option?			UK-wide	
On what date will the policy be implemented?			October 2010	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ n/a	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **n/a**	Small **n/a**	Medium **n/a**	Large **n/a**
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of	£ 250,000	Decrease of	£ N/A	**Net Impact**	£ 250,000

Key: **Annual costs and benefits : Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

This Impact Assessment updates the consultation stage impact assessment accompanying the consultation document *Disclosure of Tax Avoidance Schemes (DOTAS)* published in December 2009.

DOTAS was introduced in Part 7 of the Finance Act (FA) 2004 and came into force on 1 August 2004. It requires early disclosure of information about certain tax schemes in order to:

- provide early information to HMRC about the detail of tax avoidance schemes to allow the risk they pose to be assessed, and where appropriate to inform legislation to close loopholes;
- identify the users of those schemes to inform risk assessment and HMRC's compliance work; and
- reduce the supply of avoidance schemes by altering the economics of avoidance, reducing the returns to promoters and users as schemes are closed down more quickly.

DOTAS has subsequently been revised and extended and it now covers the whole of income tax, corporation tax (CT) and capital gains tax (CGT) (collectively known as "the main regime). It also covers stamp duty land tax (SDLT) on commercial property ("the SDLT regime"). Regulations extending the SDLT regime to residential property schemes come into force on 1 April 2010.

Regulations (made under the Social Security Administration Act 1992) apply DOTAS, to the extent that it applies to income tax, to schemes that concern National Insurance Contributions (NICs). When the proposed tax changes come into force, those elements that apply to income tax will be extended to NICs at the same time.

There is a separate disclosure regime for VAT, which is not affected by the proposed changes and therefore not included in the scope of this assessment.

How DOTAS works

DOTAS requires certain persons, normally the promoter of the scheme, to provide HMRC with information about schemes falling within certain descriptions. The promoter must explain how the scheme is intended to work and must normally do so within five days of making the scheme available to clients. Promoters are accountants, solicitors, banks and financial institutions and small firms of specialist promoters known as 'tax boutiques'. Offshore schemes not disclosed by the promoter must be disclosed by the user.

The descriptions of schemes required to be disclosed under the main regime are known as "hallmarks". There are currently eight. Five generic hallmarks target new and innovative schemes: three, more objective, hallmarks target known risk areas. The SDLT regime has a separate description.

A scheme reference number (SRN) system enables HMRC to identify the users of schemes. When a scheme is disclosed, HMRC allocates a SRN and notifies it to the promoter. The promoter passes the SRN to their clients who in turn must use it to identify themselves to HMRC, normally by including the SRN on a tax return. The SRN system currently does not apply to SDLT. But regulations extending the SRN system to the SDLT regime will come into force on 1 April 2010.

The SDLT changes described above have been the subject of a separate consultation and the responses to that consultation have been published on HMRC's website at www.hmrc.gov.uk/consultations/index.htm. The SDLT changes have also been the subject of a full impact assessment which has been published on HMRC's website at www.hmrc.gov.uk/better-regulation/ia.htm.

There are information powers enabling HMRC to investigate cases of suspected non-compliance and penalties for failing to disclose a scheme and failing to pass on or report a SRN.

The impact of DOTAS

Tax avoidance schemes are promoted and used by a relatively small number of businesses and individuals. The number of disclosures of avoidance schemes is currently around 100 a year for the main regime and 30 for SDLT.

But the amounts of tax at risk from avoidance and protected by DOTAS are considerable. Since 2004 DOTAS has informed 49 measures announced at Budget or PBR, up to and including PBR 2009, that have together blocked off over £12 billion in avoidance opportunities.

DOTAS provides early information about new and emerging avoidance threats, allowing, where appropriate, Ministers to announce a measure ahead of PBR or Budget stopping the scheme before it can lead to significant tax losses. In some cases such an announcement has been made within days of information being received.

Since DOTAS was introduced HMRC has adopted a project management approach to enquiries into tax returns, using SRNs as the focus.

Weaknesses inhibiting the performance of DOTAS

HMRC has identified five weaknesses that inhibit the performance of DOTAS.

Penalties

Under the current penalty regime the maximum penalty that a promoter faces for deliberate non-compliance is in practice normally no more than £5,000. This is not sufficient to deter a small but active group of promoters who appear to regard a potential penalty of that size as being a cost of the scheme to be defrayed from the (often very considerable) rewards from selling the scheme to clients. There have been five instances where a promoter has paid a penalty of £5,000 without a formal tribunal hearing, long after the scheme should have been disclosed. Such behaviour subverts the policy intention of DOTAS, which is to provide HMRC with early information that could lead to a Government announcement of legislation effectively stopping the scheme before it can lead to a significant tax loss.

'Introducers'

FA 2007 provided HMRC with powers to investigate cases where it suspects that a promoter had failed to disclose a scheme as required. These include powers to require a person so suspected to explain why the scheme is not notifiable by them. HMRC is increasingly encountering persons who 'advertise' the existence of a scheme to potential clients, but they are not themselves a promoter of the scheme and do not know its detail. Rather they introduce potential clients to the promoter. HMRC has no powers to require such persons to identify the promoter and generally they choose not to do so voluntarily.

The event that triggers disclosure of a marketed scheme

The event that currently triggers the disclosure of a marketed scheme is the making by the promoter of the scheme 'available for implementation' by clients. It has become clear that this event is relatively late in the marketing process, later than was envisaged when the rule was drafted. Moreover, HMRC is aware of cases where a promoter has exploited the rule so that the scheme is not available for implementation by clients until just before implementation, despite those clients having been signed up to the scheme much earlier. Consequently, the current rule tends to provide HMRC with insufficient time to put forward legislative counter-action against a scheme, and Ministers to announce it, before a scheme is implemented.

Information about scheme users

The SRN system has proved a reasonably robust means of identifying users of disclosed tax avoidance schemes. However, it has two inherent weaknesses.

Firstly, HMRC normally identifies users only when returns are submitted, which can be many months after the scheme is implemented. The lack of early information about the number and type of scheme users makes it difficult for HMRC to estimate the tax at risk in real time and make informed choices about which schemes to counter by legislation. It also makes it difficult for HMRC to make informed choices about how to allocate and prioritise resources to compliance work on users. Estimating tax at risk and identifying resources required in real time is of increasing importance in the current fiscal climate.

Secondly, limited partnerships apart, it is difficult for HMRC to identify taxpayers who fail to report a SRN. Improvements have been made to the system to reduce error, but there is still a risk that a scheme user may deliberately fail to report a SRN in the hope of avoiding an enquiry.

The hallmarks

The current hallmarks are heavily focussed on new and innovative avoidance schemes (through the generic hallmarks) with only three hallmarks targeting specific risk areas (leasing, income tax losses and pension contributions) with more objective descriptions. However, an increasing number of schemes of concern to HMRC rely upon 'old tax technology' that is not disclosable (e.g. Employee Benefit Trust and similar schemes seeking to avoid tax and NICs on employment income). The number of such schemes may grow in response to changes in the tax system. For example, HMRC is already aware of such schemes that target the 50 per cent income tax rate (e.g. by converting income into capital).

The current hallmarks also largely focus upon marketed tax schemes. Since 2004 there has been a marked reduction in marketed avoidance schemes accompanied by a shift by some promoters and taxpayers towards more bespoke arrangements. In principle, bespoke avoidance schemes are within the scope of the generic hallmarks, but in practice the main tests of confidentiality and premium fee are not readily applicable to bespoke situations.

The options considered

Option 1: Do nothing

Taken together the weaknesses described above result in DOTAS operating to a significant degree below what it is capable of. Moreover, it would be reasonable to expect that these weaknesses would be increasingly exploited as some scheme promoters and users become more familiar with the opportunities they provide. This would result in an unacceptable loss of tax revenues and create unfair advantages for the minority of promoters and taxpayers involved in tax avoidance.

Option 2: Revise and extend DOTAS with a package of measures

This is the preferred option.

Consultation

At the 2009 PBR HMRC published a formal consultation document proposing five measures to address each of the weaknesses identified above:

- **Measure 1**: Enhanced penalties for failure to comply with a disclosure obligation. The measure would create a new daily penalty of £600 maximum, to run from the date the failure to disclose occurred, with the total amount to be set by the tribunal, taking into account the fees earned (for a promoter) or the tax saving sought (others);
- **Measure 2**: An information power to require persons who introduce scheme promoters to clients to identify who the promoter is;
- **Measure 3**: A change to the trigger point for disclosure of marketed schemes to ensure early disclosure of schemes. The new trigger would be that the detailed design of the

scheme is worked up and steps are taken to communicate the scheme's existence to third parties;

- **Measure 4**: A requirement for a promoter to provide HMRC with a periodic list of clients to whom they have issued SRNs; and
- **Measure 5**: Revised and extended hallmarks (the descriptions in regulations of schemes required to be disclosed).

The consultation document exposed draft Finance Bill legislation for comment covering Measures 1 to 4 above. It also exposed for comment draft regulations covering Measure 5. The consultation closed on 19 February. We received 19 written responses and during the consultation process HMRC also met with a number of stakeholders and held an open seminar. The consultation identified a number of issues and concerns about the detail of the legislation and a number of small but significant changes have been made to the draft legislation as a result. A response to the consultation is published alongside this impact assessment at www.hmrc.gov.uk/consultations/index.htm

Implementation

Budget 2010 announced that Finance Bill 2010 will include legislation that would introduce Measures 1 to 4 as described above. It also announced that Descriptions Regulations, not dependent upon the Bill, will revise and extend the DOTAS 'hallmarks' (descriptions of schemes required to be disclosed).

The Bill will contain substantive provisions and powers to make regulations. The substantive powers will come into effect on separate days to be appointed by Order. It is expected that the substantive provisions and the regulations (including the Descriptions Regulations) will come into effect on a common date in autumn 2010. NICs regulations mirroring the tax changes, insofar as they apply to income tax, will come into force at the same time as the tax changes.

This impact assessment considers the 5 measures announced at Budget 2010 as a package, since the effect of the package is greater than the sum of the individual measures. However, whereas Measures 1 to 4 are included in the Finance Bill, Measure 5 will be implemented solely by means of regulations, which will be the subject of further discussions with business. Consequently, this assessment will be updated when regulations implementing Measure 5 (hallmarks) are made and laid.

Impacts on promoters and users – general description

Measure 1: Enhanced penalties for failure to disclose a scheme

The measure itself does not create a new disclosure obligation or change the circumstances in which a person is liable to a penalty (but measures 2 and 4 each create a new information reporting requirement, failure to comply with which would be subject to a penalty)

The measure provides for an increased penalty for failure to comply with existing disclosure obligations. It targets the small proportion and number of persons who fail to comply with a statutory obligation either to disclose a scheme or to provide information in response to a formal notice seeking information concerning that scheme.

Measure 2: A power to require persons who introduce potential clients to a promoter to provide information about the promoter

A person issued with a notice by HMRC would be required to provide the name and address of the person who supplied them with the scheme whose existence they are communicating to third parties.

If the current level of casework remains unchanged, HMRC would expect to issue a maximum of 20 such notices in a year.

Measure 3: A change to the time when a promoter must disclose a marketed scheme to HMRC

Scheme promoters would have to amend their processes to identify schemes requiring to be disclosed earlier in the process than now. They would have to update their internal guidance and train staff.

The revised rule is targeted at actively marketed schemes and is not intended to affect other schemes, which although not fully 'bespoke' are not actively marketed (e.g. the circumstances where a promoter is approached by a client and provides them with a 'packaged solution'). Disclosure of schemes not actively marketed will continue to be triggered, as now, by the earlier of the promoter making a proposal for arrangements available for implementation or becoming aware of the client entering into a transaction forming part of the arrangements.

Measure 4: Promoters to provide HMRC with periodic information about clients to whom they have issued a scheme reference number

Scheme promoters will have to introduce processes for capturing data and generating reports about clients to whom they are required to issue a SRN. The data required will be the name and address of the client, which should be known to the promoter. Promoters would have to transmit those reports to HMRC. It is proposed that this would be done by using the KANA system, which is already used to send disclosure reports (forms AAG1 etc) to HMRC securely online.

Promoters would also have to train staff and to monitor the HMRC website for any SRNs that are withdrawn.

The impact on users would be limited. The promoter would be providing information which scheme users would normally be required to provide to HMRC at a later stage. The enhanced information should result in HMRC targeting its enquiries more effectively, reducing the number of unnecessary enquiries. However, there may be some instances where the list prompts HMRC to contact a client who has not implemented the scheme. Changes to the legislation as a result of the consultation should restrict such instances to a small number.

Measure 5: Revisions and extensions to the "hallmarks" (descriptions of schemes that must be disclosed)

Promoters would have to revise internal guidance and ensure that their staff become familiar with the new descriptions.

There would be an increase, at least initially, in the number of disclosures. Previous revisions and extensions have led to a short term spike in disclosures followed by a fall to a steady state. The current steady state is a relatively small number (around 100 disclosures a year) and the changes, if properly targeted, should not lead to a disproportionate increase in that number. They should also provide greater clarity in borderline cases.

An increase in disclosures would lead to a corresponding increase in the number of SRNs issued by HMRC, to be transmitted onwards by promoters (and reported on the new clients) and reported back by scheme users.

Compliance Costs

Each of the proposed measures would have a different impact on the costs to those providing HMRC with disclosures or other information.

Prior to consultation, HMRC proactively identified the following potential costs:

- revising internal guidance and providing staff training;
- potential infrastructure costs of collecting and transmitting the required additional information; and
- costs to promoters of changing systems to disclose marketed schemes earlier.

During consultation HMRC did not receive any responses providing estimates of the costs. Some respondents expressed concerns that the costs could be disproportionate, in particular if the hallmarks (Measure 5) were too widely drawn. On the basis of the changes that have been made to the draft Finance Bill legislation, and on the assumption that the hallmarks will be narrowly targeted, it is considered that promoters will be able to meet the requirements of the package by adapting existing systems and that the associated costs will not be significant. HMRC will review the compliance cost estimates when the regulations implementing Measure 5 are made and laid and this assessment is updated as described above.

Impact on HMRC

Costs to HMRC include:

- costs of producing guidance and communicating changes to promoters;
- costs of changing IT systems to receive client lists from promoters (estimated at £150,000 in year 1) and of matching client list data to existing systems. The total costs for this work are estimated to be less than £250,000 and have been included in HMRC's spending plans.
- potential increased costs in imposing penalties if a higher penalty leads to a greater degree of litigation

Admin Burden

The admin burden is assessed through the 'Standard Cost Model', an activity-based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.

Using the Standard Cost model the admin burden has been estimated to be £275,000 per year (2010 prices). This is the combined effect of all quantifiable measures. Measure 1 will have no impact as the admin burden is only quantified for compliant businesses. The figure above is therefore a combination of the remaining four measures. This has been calculated by considering businesses; promoters, introducers, clients and employers.

Policy Benefits

It is envisaged that the proposed changes will lead to a series of benefits to HMRC and promoters that will include:

- greater certainty about which schemes are disclosable and when, thereby reducing the costs associated with dealing with cases where disclosure is uncertain or disputed;
- reduced costs of introducing and responding to anti-avoidance legislation as the proposed measure will inform a more generic approach to legislation; and
- more effective use of HMRC's resources through better information about the tax at risk in relation to schemes and users.

Exchequer Effects

DOTAS is an information device and its main impact is to protect revenue by informing both legislation and compliance work. As reported earlier in this assessment, since 2004 DOTAS has informed legislation that has closed off over £12 billion in avoidance opportunities.

Measures 1 to 4 will introduce further incentives for timely and accurate disclosures. Two broad effects would be expected. Firstly an improvement in the flow of information with a consequent acceleration, for schemes with significant tax risks, of legislation closing the scheme down. For schemes with the most substantial tax risks, the objective would be to make the legislation effective from a date before the scheme is implemented and tax revenue potentially lost. The second broad effect is that, if the legislation is perceived to be effective, promoters will not market schemes that are high risk of being closed down before they can be implemented.

We have drawn upon the evidence of avoidance schemes recently closed by HMRC through DOTAS to assess the impact of the package and we estimate that it will protect revenue in the region of £200 million per year. This is based on the assumption that the policy will prevent the implementation of at least one scheme per year similar to those recently legislated against by HMRC.

Judging from the current yield contribution of DOTAS we would also expect that the extended hallmarks will lead to an increase in yield from the improved detection and challenge of failed avoidance schemes. As the increased yield is based on the cumulative effect of improved detection activity over the course of a year the benefit for the first year will be affected by the fact that the measure will not come into effect until the third quarter. On this basis the increased yield from improved detection is estimated to be in the region of £25 million for 2010/11 and £50 million per year thereafter.

Specific Impact Tests

Full details of the specific impact tests are listed at:
http://berr.gov.uk/regulation/ria/toolkit/specific_impact_tests.asp.

Competition Assessment

The aim of this measure is to provide increased transparency about the marketing and use of avoidance schemes. Tax avoidance distorts competition by limiting the ability of those who do not engage in avoidance to compete fairly.

Small Firms Impact Test

Businesses of any size can buy and sell avoidance products and the objective of providing a level playing field between scheme promoters and fairness to taxpayers precludes exempting small businesses from this measure. However, HMRC does not expect the measure to have a significant effect upon small business either in absolute terms or proportionately.

Legal Aid

These proposals would not significantly increase legal aid impacts.

Sustainable Development

These proposals are in accordance with the principles of sustainable development. In particular, more effective finance arrangements across taxes promote good governance and a sustainable economy.

Privacy Impact

We have conducted a privacy impact screening for Measure 4, client lists, and have concluded that a privacy impact assessment is not required. The screening has identified a requirement for secure data handling in three areas:

- how the lists will be transmitted from the scheme promoter to HMRC;
- how HMRC associates the correct UTR to the name and address information on the lists; and
- how the combined name, address and UTR information is made available to project managers and project caseworkers.

A project is taking these issues forward. In particular, changes to HMRC's IT systems will be made to ensure that promoters can transmit client lists to HMRC electronically in a secure format.

Other impacts

These proposals will have no significant impact on emissions of greenhouse gases, or other environmental impact.

These proposals will have no significant impact on health and well-being.

These proposals will have no significant disability, gender or race equality impact.

These proposals will not have a significantly different effect in rural areas.

These proposals are compatible with the Human Rights Act.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	Title:	
HM Revenue and Customs	**Impact Assessment of Withdrawing the Furnished Holiday Letting Rules**	
Stage: Implementation stage	**Version:** 1	**Date:** 19 March 2010

Related Publications: Consultation Stage Impact Assessment of Withdrawing the Furnished Holiday Letting Rules

Available to view or download at:

http://www.hmrc.gov.uk./better-regulation/ia.htm

Contact for enquiries: Jenni Rich **Telephone:** 020 7147 0686

What is the problem under consideration? Why is government intervention necessary?

The difference in the tax treatment between furnished holiday lettings in the UK and furnished holiday lettings in the rest of the European Economic Area may not be compliant with European law.

At Budget 2009 the Government announced that the Furnished Holiday Lettings (FHL) rules would be repealed from 2010-11, and until the repeal takes effect, the current FHL rules would also apply to those with qualifying furnished holiday lettings situated elsewhere in the European Economic Area (EEA).

What are the policy objectives and the intended effects?

The policy objectives are:

- to ensure that the tax treatment of those with FHL properties within the EEA is the same as the tax treatment of those with FHL properties within the UK;
- to ensure that the tax treatment of those who let property is fair and consistent; and
- to ensure that the tax system is appropriately targeted and provides value for money.

What policy options have been considered? Please justify any preferred option.

A number of policy options have been considered, including:

- withdrawing the FHL rules (the preferred option);
- extending the existing FHL rules to properties in the rest of the EEA;
- partially withdrawing the FHL rules and extending the remaining FHL rules to properties in the EEA;
- making the FHL qualifying conditions more restrictive, and extending the FHL rules to properties in the EEA.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

HMRC intends to review the policy to establish the actual costs and effects in around three years time. This would follow the receipt of data in the 2010-11 Self Assessment tax returns.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

'I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs'.

Signed by the responsible Minister:

Stephen C. Timms

Date: 19 March 2010

Summary: Analysis & Evidence

Policy Option:	Description: Repeal FHL rules with effect from 2010-11

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Estimated one-off transitional cost of around £1,400,000 arises because all taxpayers with FHL properties in the EEA (including the UK) would need to familiarise themselves with the changes in tax treatment.
£ 1,400,000	2	
Average Annual Cost (excluding one-off)		
£ 0	4	**Total Cost** (PV) **£ 1,350,000**

Other **key non-monetised costs** by 'main affected groups'

None

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Taxpayers currently making use of the FHL legislation would have a small reduction in their on-going administrative burden as their tax calculation would be easier.
£ 0		
Average Annual Benefit (excluding one-off)		
£ 65,000	4	**Total Benefit** (PV) **£ 250,000**

Other **key non-monetised benefits** by 'main affected groups'

Ensures the tax treatment of income and gains by businesses letting furnished holiday accommodation is EU compliant.

Key Assumptions/Sensitivities/Risks Estimated Exchequer loss of £10 million in 2010-11 and yield of £25 million in 2011-12 and £15 million in 2012-13. It has been assumed that individuals are the vast majority of the users of the FHL rules.

Price Base Year 2009	Time Period Years 5	**Net Benefit Range** (NPV) **£ - 700,000 to £ -1,100,000**	**NET BENEFIT** (NPV Best estimate) **£ -1,100,000**

What is the geographic coverage of the policy/option?	EEA			
On what date will the policy be implemented?	6 April 2009			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ No change			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ 0			
What is the value of changes in greenhouse gas emissions?	£ 0			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro 50p to £3	Small 50p to £3	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of	£ 0	Decrease of	£ 65,000	**Net Impact**	**£** -65,000

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Background

The Furnished Holiday Lettings (FHL) legislation applies to property businesses that rent out qualifying holiday accommodation. In order to qualify, during the relevant period the holiday accommodation must have been:

- available for commercial letting as furnished holiday accommodation to the public for at least 140 days;
- actually let to the public for at least 70 days;
- not let to the same person continuously for more than 31 days, during a period of at least 210 days;
- let with a view to a profit; and
- situated within the UK.

For an individual with a continuing FHL business the relevant period is the tax year.

Holiday lettings that do not meet these conditions are subject to the normal rules for tax on income and capital gains from let property.

The FHL legislation allows property businesses to treat their letting of qualifying UK furnished holiday accommodation as a trading activity for certain specific tax purposes. These purposes include:

- loss relief;
- capital allowances;
- landlords' energy saving allowance (LESA);
- some capital gains reliefs (including roll over relief and entrepreneurs' relief); and
- pension relief.

This treatment differs from the normal tax treatment of income and gains from let property.

The FHL rules apply to individuals and partnerships who are within the charge to income tax and capital gains tax, and companies within the charge to corporation tax. For further details please see http://www.hmrc.gov.uk/manuals/pimmanual/PIM4100.htm.

The Issue

The FHL rules provide beneficial treatment to those renting properties in the UK compared to those renting similar properties elsewhere in the EEA. As a result of this discrepancy, the FHL legislation may not comply with European law.

The Government is committed to delivering a fair tax system wherever possible, and recognises that legislation in this area needs to provide clarity and certainty for businesses and their advisers.

The Options

The Government is obliged to ensure that its legislation does not contravene European law, and is committed to providing certainty of treatment for taxpayers. It is therefore considered unsatisfactory to do nothing.

The European Commission is responsible for ensuring compliance with European law. Where the European Commission, acting on its own initiative or as a result of a complaint to it, considers a member state's (i.e. a European country's) legislation does not comply with European law, it has the power to initiate infraction proceedings. Infraction proceedings can result in the member state being subject to significant fines. In addition, a party incurring a loss as a result of a breach in European law may be entitled to compensation from the member state for that loss.

As there were doubts about whether the FHL rules complied with EU law, the government acted swiftly to equalise the rules as they apply to UK properties and properties elsewhere in the EEA. Until a more permanent solution is delivered, the current FHL rules will also apply to those with qualifying furnished holiday lettings situated outside the UK, but within the EEA.

In consultation with industry representatives and accounting bodies, various options were considered. These mainly fell into four general categories:

- withdrawing the FHL rules.
  This would mean that FHL businesses would continue to be taxed as property businesses, but they would no longer be treated as if they were trading for certain specific tax purposes. They would be treated as having a property business for all relevant tax purposes;
- extending the FHL rules to properties in the rest of the EEA.
  This would mean that UK taxpayers who had an FHL business elsewhere in the EEA could claim the same tax reliefs as FHL businesses in the UK;
- partially withdrawing the FHL rules, and extending the remaining FHL rules to properties in the rest of the EEA.
  The FHL rules treat FHL businesses as if they were trading for certain specific tax purposes. A partial repeal would retain some of these purposes (for example Capital Allowances), and remove others (for example loss relief). The remaining FHL rules would then be extended so that they applied equally to properties in the EEA; and
- making the FHL qualifying conditions more restrictive, and extending the FHL rules to properties in the rest of the EEA.
  The qualifying conditions could be made more restrictive (for example only applying to properties that have planning restrictions on their use, or increaseing the number of days that the property has to be let for). The newly restricted FHL rules would then be extended so that they applied equally to properties in the EEA.

Informal Consultation

The changes to the FHL rules were first announced at the 2009 Budget (on 22 April 2009), to allow those affected by the withdrawal time to plan. Since then the government has been carefully listening to the views of those affected.

At the 2009 Pre-Budget Report (on 9 December 2009), HMRC published the following items, and welcomed comments on them from those affected, accountants, and the general public:

- a consultation stage Impact Assessment, *Impact Assessment of Withdrawing the Furnished Holiday lettings Rules*, explaining the anticipated impacts of this change;
- draft legislation, *Draft Legislation to Repeal the Furnished Holiday lettings Rules From 2010-11*; and
- a Technical Note, *Withdrawing the Furnished Holiday Lettings Rules From 2010-11*, explaining the full effects of the repeal.

A limited amount of feedback was provided on these documents, and due consideration has been given to the points raised.

Officials have also met industry representatives and accounting bodies to discuss the policy and its impacts.

The Decision

Some of the options put forward by the tourism industry may not have complied with European law. Additionally, the alternative options all involved extending the rules to holiday accommodation abroad. Such businesses are in competition with UK holiday accommodation providers. It was not considered to be the best way to support the UK tourist industry.

It has been decided that the FHL rules will be repealed from 6 April 2010 for income tax and capital gains tax purposes, and from 1 April 2010 for corporation tax purposes.

This impact assessment looks at the expected impacts of that decision.

Taxpayer Populations

The FHL rules apply to landlords who supply furnished holiday accommodation, which satisfies certain qualifying conditions. The rules do not apply to landlords of furnished holiday accommodation that fail to meet the qualifying conditions during the relevant period. The FHL rules do not apply to hotels, bed and breakfasts, some caravan parks and some holiday parks.

It has been assumed that, prior to 22 April 2009 (Budget Day 2009):

- all individuals with qualifying furnished holiday lettings situated in the UK (UK FHL) will have completed the FHL section of their income tax return; and
- all individuals with qualifying furnished holiday lettings situated elsewhere in the EEA (EEA FHL) will have completed the foreign land and property income pages of their income tax return.

Following the Budget 2009 announcement, UK taxpayers with EEA FHL who wished to take advantage of the FHL rules, completed the FHL section of their tax return. Those who did not choose to claim FHL treatment for their EEA FHL business completed the foreign land and property income pages of their tax return.

The following table gives estimates of the number of taxpayers who reported income from furnished holiday lettings, or income from overseas property, for 2007-08. These figures are derived from Self Assessment returns.

Number of taxpayers declaring income on their 2007-08 tax returns (prior to 22 April 2009)	
Furnished Holiday Lettings income	Foreign land and property income
60,000	45,000

There is a time lag between the tax returns being submitted and the time at which tax return data are available for analysis. Therefore the data currently available for analysis, about those with furnished holiday letting situated elsewhere in the EEA and who have taken advantage of the FHL rules, are not yet complete.

However, we have identified at least 5,000 individuals who have claimed FHL income for 2007-08 for the first time since 22 April 2009. We have assumed that these individuals can be attributed to those claiming FHL treatment for properties in the EEA for the first time.

Since 22 April 2009 we have also seen a significant increase in the amount of FHL income declared for 2007-08 by those who had previously declared UK FHL income. We have assumed that this increase can be attributed to those with UK FHL income who also have EEA FHL income, and who have claimed FHL treatment for properties in the EEA for the first time. It is more difficult to estimate the number of these individuals.

There may be a small number of individuals with EEA FHL, who have chosen not to claim FHL treatment for those properties in 2007-08.

For the purposes of this impact assessment, we have presented an upper bound for the compliance costs. We have assumed that all taxpayers with income from foreign land and property would be affected by the change in the tax treatment of FHL situated in the EEA and that all taxpayers with income from UK FHL would be affected by the change in the tax treatment of FHL situated in the UK. We therefore estimate that there are 60,000 UK FHL businesses, and up to 45,000 EEA FHL businesses (that are taxed in the UK). These are top end estimates and HMRC administrative data indicate that the actual number of individuals who have claimed FHL treatment for properties in the EEA may be much lower than this.

From the information contained on the tax returns, we are unable to determine in a robust way the location of the qualifying FHL properties. Although there is some limited external data available on the general location of holiday properties, we are unable to identify which of those would qualify under the FHL rules.

HMRC administrative systems do not collect such a detailed level of data in respect of companies. We are therefore unable to estimate precisely the numbers of companies which would be affected by repealing the FHL legislation. Companies House records show that 3,000 companies are classified as providing camp sites and other short stay accommodation but not all of those companies identified under this category would be affected by the repeal of the FHL rules: based on their trade description as well, fewer than 1,250 companies would be considered likely to be affected. There may also be a number of companies who have a small amount of FHL income to supplement their main source of income, but judging by the way in which these companies describe their activities, FHL is unlikely to be a significant part of their income. It has been assumed that individuals form the vast majority of the users of FHL rules.

The following table shows estimates of the total income levels of those individuals with income from Furnished Holiday Lettings, compared with the total income level of the overall population.

2007-08 income tax returns, percentages			
Total taxable income (annual taxable income after deductions and loss relief).	Overall population	Individuals with income from EEA FHL	Individuals with income from UK FHL
< £20,000	58%	25%	49%
£20,000 to < £30,000	21%	12%	15%
£30,000 to < £50,000	15%	21%	19%
£50,000 to < £70,000	4%	11%	6%
£70,000 to < £100,000	2%	11%	4%
£100,000 and over	2%	21%	7%

The figures shown above for individuals with income from EEA FHL, are based on the 2007-08 income tax returns that we have identified as including FHL income for the first time since 22 April 2009. The data on those claiming FHL treatment for properties in the EEA are not complete as there are time lags between returns being received and being available for analysis. However, the results are likely to be indicative of the overall EEA FHL population.

When compared to the income pattern of the UK taxpaying population as a whole, those individuals with UK FHL income tend to have slightly higher incomes than those without FHL income. When we look at those individuals with EEA FHL the difference is even more marked. Almost a half of individuals with UK FHL income, and a quarter of those with EEA FHL income, have an annual net income of less than £20,000, whereas nearly 3 in 5 individuals in the UK taxpaying population are in this category. Only 8 per cent of UK taxpayers have more than £50,000 annual net income, but 17 per cent of those with UK FHL income and 43 per cent of those with EEA FHL income have more that £50,000 annual net income. Over 1 in 5 of those with EEA FHL income have an annual net income of more than £100,000, whereas only 1 in 50 individuals in UK taxpaying population are in this category.

Impacts of Temporary Extension

There are two elements to the withdrawing the FHL rules. Firstly, in 2009-10, the FHL rules were temporarily extended to all properties in the EEA, secondly the FHL rules are to be withdrawn with effect from 2010-11 for all FHL properties.

There would be a one-off compliance cost for taxpayers with FHL in the EEA (but outside of the UK) as the tax treatment would change for 2009-10. All such taxpayers would need to familiarise themselves with the new guidelines as they would no longer be eligible for certain allowances and reliefs in 2009-10. As an upper bound for the one-off increase in compliance costs of the temporary extension we have assumed an average hourly cost of £20 and 20 minutes for all the 45,000 taxpayers reporting income arising from foreign land and property to become familiar with the change in legislation and calculate the tax consequences. This gives rise to a one-off increased compliance cost of £300,000. To mitigate the administration burden on landlords with FHL in the EEA, the interim extension of the FHL rules to EEA properties is optional. Therefore those landlords wishing to remain outside the FHL rules could do so.

We estimate that this extension reduced the tax received by the exchequer by £10 million.

Loss relief

Approximately 15,000 individuals and 500 partnerships set UK FHL losses against their other income.

Whilst the withdrawal of the FHL rules will effect how losses can be used, loss relief will still be available. Under the FHL rules, losses are treated in the same way as trade losses. After the FHL rules are withdrawn, FHL losses will be treated as losses made by a property business.

Currently companies can set their FHL losses against their income from other sources in the accounting period that they made the loss or the previous accounting period, or against their future FHL profits. Under the property income rules companies will be able to set their FHL losses against income from other sources in the accounting period that they make the loss or future accounting periods. The main impact on company losses will be the timing of relief.

Currently individuals can set their FHL losses against their income from other sources in the tax year that they make the loss or the previous tax year, or against future FHL profits. There are special rules for losses incurred in the first four tax years, or the last 12 months of the FHL business. Under the property income rules individuals will be able to set their FHL losses against other property income in the tax year that they make the loss or future tax years.

The FHL rules are only available to commercial businesses run with a view to a profit, although some of these businesses would have made losses from time to time, we anticipate that the majority of these businesses would return to profitability in the longer term. Therefore for individuals and partnerships the main impact on tax relief for the losses they incur will be the timing of relief.

We estimate that the impact of changing the way in which loss relief is given will be a £20 million increase in tax due for 2010-11. This is based on the average effective rate of income tax of individuals with FHL income, and the total FHL loss relief claimed in 2007-08 by individuals and partnerships. This impact is likely to decrease over time.

Self-Assessment returns provide some limited information on the characteristics of those affected. Those making use of the FHL loss rules tend to have higher incomes than others with FHL income, and substantially higher income than the population in general. This is shown in the table below.

2007-08 tax returns, percentages				
Total taxable income (annual taxable income after deductions and loss relief).	Overall UK income tax population	All individuals with income from FHL	Individuals with UK FHL losses offset against total income	Individuals with EEA FHL losses offset against total income
< £20,000	58%	49%	34%	25%
£20,000 to < £30,000	21%	15%	15%	12%
£30,000 to < £50,000	15%	19%	22%	21%
£50,000 to < £70,000	4%	6%	9%	11%
£70,000 to < £100,000	2%	4%	7%	11%
£100,000 and over	2%	7%	13%	21%

Tax returns do not capture information on the location of the furnished holiday letting, but analysis of 2007-08 tax returns shows that almost a quarter of those taxpayers setting UK FHL losses against other income, and almost a third of those setting EEA UK FHL losses against other income, live in London or the South East. Additional, a high proportion of individuals with UK or EEA FHL income live in the South West. This does not necessarily reflect the location of their FHL property.

Taxpayers with income from furnished holiday lettings, by registered address of the taxpayer				
Government Office Region	All individuals with income from UK FHL	All individuals with income from EEA FHL	Individuals with income from UK FHL with losses offset against total income	Individuals with income from UK FHL with no losses to offset
North East	3%	3%	4%	3%
North West	8%	10%	9%	8%
Yorkshire & Humberside	8%	8%	8%	8%
East Midlands	5%	7%	6%	5%
West Midlands	6%	6%	8%	6%
East of England	9%	8%	9%	9%
London	9%	11%	9%	8%
South East	13%	21%	15%	12%
South West	22%	15%	18%	23%
Wales	7%	4%	5%	7%
Scotland	9%	4%	8%	9%
Northern Ireland	1%	2%	1%	2%

NB due to rounding columns and rows may not total

Computation of profits

Currently FHL profits and losses are calculated under the property income rules. This treatment will continue after the withdrawal of the FHL rules.

FHL businesses will still be able to claim business expenses (such as mortgage interest, the cost of repairs, rates, utilities and employees' wages) as a deduction against their taxable income, in the same way as they do now.

Capital Allowances

Under the FHL rules, capital allowances are available for expenditure incurred on plant and machinery used within the FHL property. Following the withdrawal of the FHL rules:

- capital allowances will continue to be available for expenditure incurred before 6 April 2010 (or 1 April 2010 for companies) on plant and machinery used by the FHL businesses within the FHL property;
- capital allowances will continue to be available for expenditure incurred on plant and machinery used by the FHL businesses, but not within the FHL property (e.g. a business computer); and
- capital allowances will no longer be available for expenditure incurred on plant and machinery used by the businesses within the FHL property. Businesses will be able to claim the wear and tear allowance for these items instead. The wear and tear allowance is a tax deduction equal to 10 per cent of net rents given to landlords of furnished houses (but not currently to FHL landlords), to cover the costs of replacing plant and machinery within those houses. The wear and tear allowance does not depend on the amount actually spent on these items.

In 2007-08 the total capital allowances claimed by individuals and partnerships with FHL businesses was £35 million. In that year, FHL receipts of the same population totalled approximately £530 million. We estimate that over £50 million would have been available under the wear and tear allowance. The figures declared in the 2006-07 tax returns show a similar result. In the short to medium term therefore we estimate that more allowances would be available after the repeal of FHL rules.

In the longer term, there might be an impact on businesses that incur significant expenditure on new plant and machinery. We expect the number of such businesses, however, to be small.

There will also be an impact for new FHL businesses who convert non-residential buildings into holiday accommodation, as the conversion costs are likely to be capital. Those renovating existing residential buildings or existing holiday accommodation are less likely to be affected as replacing kitchens, bathrooms and other fittings in a useable property will not normally be capital expenditure.

Capital allowances are also available to companies under the FHL rules. We do not hold specific data on the capital allowances claimed by FHL companies; however we expect the effect on individual companies to be similar to the effect on individuals and partnerships.

Overall, we estimate that the impact of replacing capital allowances with the wear and tear allowance would be a £5 million reduction in tax due.

It has been suggested that the removal of capital allowances will act as a disincentive to businesses to invest in furnishing their properties. We do not consider that this will be the case. Tax relief will still be available for these items, through the wear and tear allowance. The wear and tear allowance does not directly reflect the expenditure incurred on replacing fixtures and furniture within furnished accommodation, but is instead linked to net rents. Well appointed properties are likely to achieve higher net rents and so the wear and tear allowance is considered a fair relief. Alternatively businesses may choose to use the renewals basis, which allows tax relief for expenditure on replacement plant and machinery.

We think market forces are the main driver for businesses to provide quality accommodation, as good quality accommodation achieves higher rents and a more sustainable customer base than poor quality accommodation. We believe market forces will continue to encourage sustainable investment in this area.

Landlords Energy Savings Allowance (LESA)

FHL landlords are currently unable to claim the LESA. The LESA allows landlords of residential properties to claim a tax deduction for capital expenditure on certain energy saving improvements to their properties. After the FHL rules are withdrawn FHL businesses will be entitled to claim the LESA.

We estimate the effect of this change will be negligible.

Capital Gains

HMRC administrative systems do not collect such a detailed data in respect of capital gains of FHL businesses. We are therefore unable to estimate the numbers of businesses which would be affected by the withdrawal of the FHL legislation. In 2007-08 there were 9,000 individuals with FHL income and capital gains. Not all of these gains would necessarily relate to FHL assets, and only gains relating to FHL assets will be affected by a withdrawal of the FHL rules.

There are various capital gains reliefs currently available under the FHL rules:

- entrepreneurs' relief;
- roll over relief on the replacement of business assets;
- relief for gifts of business assets;
- relief for loans to traders; and
- exemption for disposal of shares by companies with substantial shareholdings.

The data available to HMRC are not sufficient to calculate the impacts of each relief accurately but it is assumed that rollover relief and entrepreneurs' relief are the most widely used. We estimate the number of claims for the other FHL CG reliefs is likely to be very small, and the tax involved negligible.

For capital gains purposes, FHL businesses will cease to be treated as a trade from 6 April 2010 for individuals (or from 1 April 2010 for companies). After this date, FHL businesses will continue to treat periods up until 5 April 2010 (or 31 March 2010 for companies) as trading periods for capital gains purposes.

For individuals with an existing FHL business that ceases to be treated as a trade from 6 April 2010, entrepreneurs' relief will continue to be available until 5 April 2013 (provided the other conditions for the relief are satisfied) on disposals of assets used in the FHL business at 5 April 2010. For individuals with an FHL business which ceased before 6 April 2010, entrepreneurs' relief will also remain available for up to three years after the date of the cessation. Therefore, the withdrawal of entrepreneurs' relief for individuals with existing FHL businesses will have no effect on Exchequer receipts for the years up to 2013-14. We estimate the impact on new FHL businesses during this period to be negligible.

Where a company has an FHL business that ceases to be treated as a trade from 1 April 2010, the capital gains consequences may be confined to roll-over relief (see next paragraph). Where the FHL business is only a minor part of the company's activities, the cessation of trading treatment may not mean the company ceases to count as a "trading company" (or the "holding company of a trading group"). The substantial shareholdings exemption and the other capital gains reliefs in relation to disposals of shares in trading companies (or groups) may therefore continue to be available. Overall we estimate the impact of withdrawing the capital gains reliefs for FHL businesses to be negligible where the FHL business is carried on by a company.

Roll-over relief will not be available in respect of acquisitions of FHL assets from 6 April 2010 for individuals and partnerships (or from 1 April 2010 for companies). Gains on disposals of assets used in FHL businesses before 6 April 2010 (or 1 April 2010 for companies) may qualify for relief after those dates, but on a restricted basis to take account of non-trade use. Roll-over relief defers the tax charge on capital gains, rather than providing an absolute reduction in tax, so the impact will be one of timing. We anticipate that the number of disposals of chargeable FHL assets in any year will be low. When viewed as group, we do not think that there will be sufficient instances of qualifying chargeable gains, in any one year, for the withdrawal of the FHL rules to have more than a negligible total costing. We estimate that the additional tax generated from the absence of roll-over relief for FHL businesses will be negligible.

So taking these considerations together, we consider the consequences to Exchequer yield over the next five years will be negligible. We anticipate that there will be increased yield from chargeable gains in the longer term, but we do not hold sufficient information to produce a robust estimate of this increase.

Although we estimate the number of affected chargeable gains in any year to be low we do recognise that the impact on individual businesses when they make such a disposal may be material.

Pension relief

Pension relief is not available to companies, nor is it available to individuals on distributions from a company. Therefore only individuals (and individual members of a partnership) will be affected by this change.

An individual can claim tax relief on payments they make into a pension scheme. The amount of relief available in a tax year is limited to the greater of £3,600 or 100 per cent of their total qualifying income. Under the FHL rules, FHL income is qualifying income for pension relief purposes. This means that the withdrawal of the FHL rules would reduce the maximum tax relief available for pension contributions.

Very few individuals make sufficient payments into pension schemes to enable them to claim the maximum available pension relief. Most individuals with FHL income have other qualifying income, or contribute less than £3,600 to a qualifying pension scheme.

In 2007-08 all of those with FHL income claimed pension relief worth a total of £6.5 million. Almost two thirds of the FHL landlords who claimed pension relief did not contribute more than £3,600. In 2007-08 fewer than 1,800 individuals would have been affected by a change to the FHL pension relief rules, however, the majority of those had low taxable incomes.

As individuals can obtain tax relief on contributions to a pension scheme, up to a maximum of £3,600 a year, without regard to their qualifying income, and our analysis shows that the majority of individuals with FHL income would not be adversely affected by this change, we estimate that the impact of repealing this relief would be negligible.

Total impact on tax

We estimate that the total impact on the tax received by the exchequer will be a £10 million reduction in tax in 2010-11, a £25 million increase in tax in 2011-12, and a £15 million increase in tax in 2012-13. The ongoing increase in tax may change over the longer term.

These figures have been estimated on a receipts basis. The impact on tax receipts are normally shown on a receipts basis, because this is the impact felt by the Exchequer. Under self assessment, income tax is normally paid by instalments. Some tax will not be paid until after the end of the tax year to which it relates, this affects the year in which tax changes are recognised.

The reduction in tax in 2010-11 is a result of the temporary extension of the FHL rules to properties situated elsewhere in the EEA, which was announced at Budget 2009.

The increase in 2011-12 is much larger, because it includes the full increase in tax for 2010-11 and some of the increase in tax for 2011-12. This is a result of using the receipts basis.

Compliance Cost

There was a one-off compliance cost for taxpayers with furnished holiday lettings in the EEA outside of the UK as the tax treatment changed in 2009-10. All such taxpayers needed to familiarise themselves with the new guidelines as they became eligible for certain allowances and reliefs. As an upper bound for the one-off increase in compliance costs of the temporary extension we assumed an average hourly cost of £20 and 20 minutes for all the 45,000 taxpayers reporting income arising from foreign land and property to become familiar with the change in legislation and calculate the tax consequences. This gave rise to a one-off increased compliance cost of £300,000.

Once the FHL rules are withdrawn, we expect most FHL landlords would fall within the property income tax rules that apply to property businesses. But there are some businesses who would still need to decide whether they fall within these rules or the trading income rules. This decision would depend on the facts. Most taxpayers with FHL income from properties situated elsewhere in the EEA would have made such an assessment recently. They would need to update that assessment, but we have assumed this cost would be negligible. For the 60,000 taxpayers with UK FHL income, we have assumed this assessment would take an average of 20 minutes. This acknowledges that the decision would be less time consuming for most taxpayers, but more time consuming for others. At an average hourly cost of £20 we estimate an additional one-off increased compliance cost of £400,000.

For the purposes of this impact assessment we have assumed that the impact on those who are actually trading would be negligible. We have also presented an upper bound for the impacts by assuming that all taxpayers with FHL income would fall within the property income rules.

There would be a one-off compliance cost for all taxpayers with income or gains from UK or EEA furnished holiday lettings. They would need to become familiar with the new tax treatment around loss relief, relief for capital expenditure, some capital gains reliefs and pension reliefs applicable from 2010-11. The new tax treatment could affect up to 105,000 taxpayers – of which there are 60,000 taxpayers with furnished holiday lettings in the UK, and up to 45,000 taxpayers with furnished holidays lettings in the rest of the EEA. We have assumed an average hourly cost of £20 and 20 minutes for all these 105,000 taxpayers to become familiar with the new guidance following the change in legislation, resulting in an additional one-off increased compliance cost of £700,000.

Therefore the total one-off compliance costs come to £1,400,000 over the two year period of implementation.

Administrative burden

HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular; the admin burden of disclosing information to HMRC or to third parties. This burden is assessed through the “Standard Cost Model” (SCM), an activity based costing model which identifies what activities a business has to do to comply with HMRC’s obligations, and which estimates the cost of these activities, including agent fees and software costs.

Once the FHL rules are withdrawn there will be an on-going compliance saving for all taxpayers with furnished holiday letting income, particularly for those setting such losses against other sources of income or claiming capital allowances, as they would benefit from having a simplified tax calculation. Based on income tax return data, we estimate that 15,000 individuals set their furnished holiday letting losses against their other sources of income. These individuals would no longer be required to calculate this set off. We have assumed an average hourly cost of £20 per hour and a 5 minute saving for the loss relief computation, resulting in a reduction in the administrative burden of £25,000.

Based on income tax return data, we estimate that each year 25,000 individuals claim capital allowances for assets used within UK FHL properties. These individuals claiming capital allowances would move onto the wear and tear allowance, which is simpler to calculate. We have assumed an average hourly cost of £20 per hour and a 5 minute saving for replacing the capital allowances computation with the wear and tear allowance computation, resulting in a reduction in the annual administrative burden of £40,000.

Taxpayers with income from both furnished holiday lettings and other property income will combine their income from these sources on their tax return. It has been assumed that any such reduction in administrative burdens from this would be negligible.

Overall the repeal will therefore lead to ongoing admin burden savings to business of £65,000 per annum.

Net Benefit

The additional one-off compliance costs and the ongoing admin burden savings lead to a net cost of £1,100,000 over a five year period. This has been calculated on the basis of a top end estimate that assumes a population of taxpayers with furnished holiday lettings in the rest of the EEA of 45,000. It is likely that the actual net cost will not be this big. If we assume lower bound population of 15,000, the resultant net cost would be £700,000.

Tourism

According to the latest UK Tourism Survey statistics, the domestic tourism industry was worth £21.1 billion to the UK economy in 2008. The self-catering accommodation sector is a growing sector of the UK holiday market generating £1.8 billion per annum which accounts for almost 13 per cent of all UK domestic holiday expenditure. Holiday travel using self-catering accommodation increased by around 20 per cent in the 2009 summer period compared to the previous year.

Tourism Alliance analysis of the UK Tourism Survey figures (excluding self-catering associated with holiday villages, hire boats and timeshare properties), indicates that the “holiday cottage” component of the sector accounts for 5.72 million visits (4.9 per cent) and £1.823 million (8.6 per cent) of total UK domestic tourism expenditure with an average expenditure of £55.21 per person per day. When travel purely for holidays is separated out from business travel and travel to see friends and relatives, the importance of self catering cottages is more marked, accounting for 7.6 per cent of all holiday visits, 12.4 per cent of all nights and 12.9 per cent of all revenue.

Analysis by the Tourism Alliance shows that £1.1 billion is spent by self-catering businesses and their visitors in local economies in local pubs, restaurants and attractions.

In addition, the separate The British Holiday & Home Parks Association analysis of static caravans and holiday parks indicates that caravan holiday homes account for a further 8 per cent of all tourist bed nights in the UK and £1.136 billion in domestic tourism expenditure.

Therefore, tourists staying in self-catered holiday accommodation account for almost £2 billion in domestic tourism expenditure.

As an example, Tourism Alliance suggests that if 10 per cent of self catering tourists (including those staying in caravans) cease to take holidays in the UK, tourism expenditure will decrease by £200 million.

Even if 10 per cent of FHL businesses closed, this would only translate to a 10 per cent reduction of self catering tourists taking holidays in the UK, if it is assumed that all self catering businesses use the FHL rules and all holiday accommodation is 100 per cent occupied.

The UK has a vibrant tourism industry, and this change is unlikely to affect demand for holiday accommodation in the UK. For this change to affect the UK tourism industry materially, a significant number of tourists would need to stop using FHL businesses, and not transfer to other UK alternatives.

Many providers of holiday accommodation (e.g. hotels, bed and breakfasts and those not satisfying the FHL qualifying conditions) will be unaffected by this change. Those businesses that are affected will still be able to benefit from a range of reliefs available under property income rules.

The tourism industry have stated that they see capital allowances and the capital gains roll-over relief and entrepreneurs' reliefs as the most important of the FHL reliefs. In December 2009, at the Pre-Budget Report, we set out an approach ending the FHL regime with transitional arrangements to ensure that these reliefs are withdrawn gradually over time. This will minimise the impact of the change on existing UK businesses.

In November 2009, before those transitional arrangements were announced, the Federation of Small Businesses (FSB) polled 1,000 of its members involved in the tourism industry, and 166 businesses replied. Of those businesses, 25 would consider closing their business, 71 would be put off expanding their business, and 133 would be less likely to improve the quality of their accommodation due to a straight repeal of the FHL rules. If the repeal was implemented without transitional arrangements, 83 of the respondents believed that they may have to make staff redundant over the next 12 months as a result of this change.

Tourism Alliance suggests that if 10 per cent of self catering tourists (including those staying in caravans) cease to take holidays in the UK, this could result in the loss of 4,500 jobs in rural and seaside economies. This assumes that one full time equivalent job is lost for every £50,000 reduction in tourism expenditure, which is based on analysis of employee levels of large tourism companies. Most FHL businesses will be small or medium businesses. It is not anticipated that this change will result in a 10 per cent reduction of self catering tourists taking holidays in the UK.

Due to the transitional arrangements put in place, most continuing FHL owners will not see an increase in their business's annual tax bill, though they may see an increase in capital gains tax when they dispose of the FHL property. Some individuals may pay more income tax as a result of the change, but the impact on continuing, viable, businesses is expected to be limited.

However, the changes to the way relief is given for losses and capital expenditure may affect new FHL businesses as they enter the market. Some FHL businesses require a large initial capital investment. These costs include converting non-residential properties into holiday homes, and providing furniture and equipment within the property. Currently capital allowances can be claimed on some of these costs, and if this creates a loss that loss can be set against the individual's other income. This can provide additional financial support in the early years of the business by reducing the individual's tax bill at that time. The changes will mean that, in these circumstances, the individual may not be able to reduce their tax bill at that time, but they will pay less tax on the business' future profits instead. The rules for relieving company property business losses will mean that new FHL businesses run by companies will not be affected in this way. Changing the time at which tax relief is given in these circumstances could dissuade some new businesses from entering the market. Over time this could reduce the total number of FHL properties. However, taxation is only one of the many factors individuals consider when starting a new business. The self catering market has shown strong growth in recent years, with self-catered holiday travel increasing by around 20% last year, and market forces are likely to be a continuing driver for growth in this sector.

Whilst the repeal of the FHL rules may lead to some increase in the effective rate of taxation on some FHL businesses, the tax treatment of other providers of holiday accommodation will be unaffected. As a result, even if some individuals are dissuaded from renting out their properties under the new regime, competing holiday providers are likely to step in to supply that part of the market. This will act to mitigate any reduction in the supply of holiday accommodation in the UK. We do not expect this change to materially reduce the overall number of holiday accommodation bed-spaces in the UK. We recognise that some self-catered holiday makers will not wish to change the type of holiday accommodation they use. However, we think these individuals will still be able to find suitable accommodation, because some self-catered holiday accommodation providers are not affected by this change, and we expect most FHL businesses will not close.

We believe most tourists will continue to be able to find suitable holiday accommodation within the UK. Therefore we do not anticipate that this change will have a material impact upon the wider tourism industry.

Rural Impacts

HMRC holds information analysing the location of the owners of let furnished holiday properties, but it does not hold information detailing the location of the property itself. We believe that furnished holiday properties are more likely to be located in rural areas.

Farmers may be more likely to convert non-residential buildings into holiday accommodation. Those who undertake new projects to convert agricultural buildings into holiday accommodation may not be able to claim tax relief for this expenditure as quickly as before. The changes to the capital gains roll-over relief rules may make financing future capital expenditure on FHL properties by selling land less attractive.

Defra research shows that 50 per cent of farms in England had diversified by 2005-06 'usually by letting buildings, either for industrial purposes or for the tourist industry'. The research also shows that for 56 per cent of businesses with diversified interests, diversified income accounts for a quarter or more of total farm income.

However, many providers of holiday accommodation in rural areas will be unaffected by this change, for example B&Bs, hotels, camping sites and many caravan sites. Those businesses that are affected will still be able to benefit from a range of reliefs available under the property income rules. Most current FHL owners will not see an increase in their business's annual tax bill, though they may see an increase in capital gains tax when they dispose of the FHL property. Some individuals may pay more income tax as a result of the change, but the impact on continuing, viable, businesses is expected to be limited.

We do not expect this change to materially reduce the overall number of holiday accommodation bed-spaces in rural areas, and this change is unlikely to affect demand for holiday accommodation in rural areas. Therefore we do not anticipate that this change will have a material impact upon rural areas.

Competition assessment

Applying the Office of Fair Trading competition filter to the affected sectors to assess the impact of the proposed measure results in the conclusion that an in depth competition assessment is not warranted because the estimated impacts on competition are not significant.

The repeal may have a small but positive effect on competition. The current FHL rules may result in a distortion faced by UK individuals choosing where to buy a holiday property: properties in the UK are made artificially more attractive compared to properties in the rest of the EEA. The withdrawal of the FHL rules may remove this distortion.

The change will reduce the risk of anti-competitive effects arising across Europe because it will remove the chance of similar businesses being treated differently based on the location of their property. The focus on fair and equal treatment supports the principle of fair and vigorous competition. The reform will not have an impact on businesses' or individuals' capacity to enter the property or other markets but it will help facilitate competition by ensuring that new and existing businesses are treated equally and by removing actual or potential market distortion based on the location of the property.

One objective of the change is to remove the differences in the tax treatment resulting from owning different types of property. The change will place all landlords on a level playing field, and so remove the distortion faced by individuals choosing whether to rent their properties to holiday makers or to other types of tenant. As other providers of other types of holiday accommodation may be taxed under the trading income rules, this change may create a small distortion within the holiday accommodation sector. To be taxed under the trading income rules, providers of holiday accommodation must also provide additional services, such as the provision of meals, and such treatment will depend on the facts of the case. Taxation will be one of a number of factors that will be considered when deciding which type of accommodation to provide. Supply and demand, profitability, and the level of additional work necessary in order to provide additional services are likely to be the primary deciding factors.

It has been suggested that the removal of the FHL rules will distort competition between holiday accommodation providers. We do not believe that this will be the case. Various differences exist between the different types of accommodation providers, both in terms of the accommodation and services provided, and the customer base. Where an FHL business's activities are the same as that of a hotel, the business will be taxed as a trader. The change will mean that those businesses who are in fact trading, will be taxed under the trading income rules, and those businesses who are not in fact trading will be taxed under the property income rules. So, similar businesses will receive similar tax treatment.

Small Firms Impact Test

This change would primarily affect businesses with fewer than 20 employees because businesses letting furnished holiday accommodation tend to be small. The withdrawal of the FHL rules will bring furnished holiday letting businesses into line with other property businesses, which are also predominantly small.

Analysis of tax returns suggests that the vast majority of businesses setting losses arising from furnished holiday lettings against other forms of income are small.

It was not possible to retain the FHL rules for small FHL businesses, without also extending the rules to small FHL businesses in the EEA. Therefore the change to the FHL rules will also apply to small businesses. In order to give small businesses time to plan for this change, a one year period of notice was given.

We have listened to the concerns raised by small businesses since this change was announced.

Diversity

We have considered carefully the impact on race, disability and gender, and have carried out an equality impact assessment initial screening. We have found that some groups will be affected more than others, but only insofar as these characteristics are correlated with the incidence of individuals running FHL businesses. As the changes will treat all those with FHL income equally, we have concluded that the measure has no effect on race, disability, and gender.

The consultation stage impact assessment welcomed comments on these impacts. We have not received any comments to suggest that this change will have an impact on race, disability and gender.

Other Impact Tests

Other impact assessments were undertaken and found that the withdrawal of the FHL rules should have no significant impact on legal aid or sustainable development. Assessments for carbon or environmental impacts or health impacts concluded that these issues are not applicable.

Other impacts

Increasing the tax payable on the income arising on FHL properties gives rise to slightly lower returns on investment, which could cause some taxpayers to sell their FHL property or change its use. Additionally some capital expenditure might be deferred.

Eliminating the tax advantage of furnished holiday lettings in the UK over those situated in other EEA countries would allow taxpayers to choose the location of their furnished holiday let without tax distortion.

Eliminating the tax advantage of furnished holiday lettings over other types of property would allow taxpayers to choose how they rent their properties without tax distortion (though other restrictions may apply to some properties).

Implementation plan

The changes will be legislated in Finance Bill 2010. Guidance has been published on the HMRC website, and supplementary guidance will be published shortly. Implementation of the policy will not require additional resources for HMRC.

Conclusion

A change is required to ensure that the FHL rules comply with European law.

It is recognised that neither withdrawing the FHL rules, nor an extending them (in whole or in part) to properties in the EEA would be entirely welcome. We have carefully weighed up all the impacts, costs and benefits of the options and have concluded that withdrawing the FHL rules after a period of notice has the most positive results for stakeholders and government.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

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