



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ  
**Rt Hon Michael Jack**  
**Chairman**  
**Office of Tax Simplification**

9 May 2011

*Dear Michael*

**GOVERNMENT RESPONSE TO THE OFFICE OF TAX  
SIMPLIFICATION'S RECOMMENDATIONS**

We met over the Easter recess to discuss the Office of Tax Simplifications (OTS) recent reports reviewing tax reliefs and small business tax, including IR35. As discussed, this letter outlines our response, including the decisions taken at Budget that were informed by the OTS's reviews. It also sets out priorities for the next stage of the Office's work.

We very much appreciate the work that has gone into these first reports. Both represent a significant contribution to our understanding of complexity in the tax system. They are a first step towards meeting the Government's ambitions for simplifying tax for businesses and individuals and a real achievement for the OTS.

**Small Business Tax**

First I would like to turn to the OTS review of Small Business Tax.

*Income Tax and National Insurance Contributions*

Your interim report highlights the distortions and costs created by differences in the income tax and National Insurance Contributions



(NICs) systems, and the appetite among small businesses and tax practitioners to look at potential simplification reforms. As announced in the Budget, the Chancellor and I have decided that we will examine and consult on options to integrate the operation of income tax and NICs.

We will bring forward reforms to simplify the differences between the current income tax and NICs systems and through doing so aim to remove distortions in the tax system, reduce burdens on business and improve fairness for individuals. Having considered the important role NICs play in providing entitlement to contributory benefits and the potential impacts on the rest of the income tax system from full integration, the Government's view is that income tax and NICs should remain separate. Any changes brought forward will reflect the Government's commitment to maintaining the contributory principle. We have also decided not to extend NICs to individuals above State Pension Age or to other forms of income such as pensions, savings and dividends.

As your report recognises this is a complex area of the tax system and any change will involve a wide number of policy and implementation issues. Consistent with our commitment to a more considered, deliberative approach to tax policy making, we will publish an initial consultation document later this year setting out the stages, options and timing of reform.



The consultation will cover several of the aspects set out in your report, including the definition of earnings, the calculations required, and the reliefs and exemptions in the two systems

*Recommendations on IR35*

Next, I would like to turn to IR35. The OTS report highlights that integrating income tax and NICs and reducing the difference between the tax rates on different incomes and legal forms could result in the IR35 legislation becoming obsolete. However, recognising the long timescale for introducing any major structural changes, your report also suggests three options on IR35 that could be introduced in a relatively shorter timescale.

The first option presented in the OTS report is to suspend IR35 with a view to potentially abolishing it in the longer term. I share your view that purely from the perspective of simplification this would be a positive step. However, as you acknowledge, in places IR35 remains an effective deterrent and the fiscal risks of suspension are both significant and immediate. In light of this, the Chancellor and I concluded that suspension was not the right option.

The OTS report identifies two alternatives to suspension, the first to improve the administration of IR35, and the second to replace it with a business test. In the context of IR35's administration, your report highlights that after more than ten years of experience the burden of IR35 has fallen, although it is apparent that a genuine fear of the legislation remains within the freelance workforce.



When considering the options you presented, it was clear to me that a fresh look at how HMRC administer IR35, as the OTS suggests, would bring about improvements to the current situation. I could also see that replacing IR35 with a business test could provide an opportunity to give businesses greater certainty – but I came to the conclusion that it would be very challenging to devise a test that would work for business and HMRC.

As the OTS report confirms, there is no easy answer on IR35. The Chancellor and I carefully weighed the options you presented in making our decisions at Budget. Reflecting this, and the substantial risks from suspension of the legislation, we decided that the best option is to retain IR35 with a commitment to achieve clear improvements in administration.

I have asked HMRC to undertake a thorough overhaul of the administration of this area of the tax system. HMRC will focus on providing pre-transaction clarity and certainty and restoring trust. The changes to be made will include setting up a dedicated helpline staffed by specialists, publishing guidance on those types of cases HMRC view as outside the scope of IR35, targeting compliance activity by restricting reviews to high risk cases and setting up an IR35 Forum which will monitor HMRC's new approach. To ensure consistency, HMRC have invited candidates drawn from those involved in the OTS review of IR35 review, to participate in this forum. Overall, I hope the OTS will be able



to endorse this approach, which I believe has real potential to remove much of the uncertainty and to improve transparency for business.

### **Review of reliefs**

Finally, I would like to turn to your review of tax reliefs. Over the years the number of reliefs in the tax code has increased significantly. The Government asked the OTS to identify those reliefs whose rationale is no longer valid or which unnecessarily complicate the tax system. In your report you identify over 40 reliefs that could be abolished and a further 17 that could be simplified.

Based on these recommendations and ongoing work by HMRC, the Government will be abolishing 43 reliefs in total with 7 taking effect from Budget and 36 in the Finance Bills for 2012 and after. The Government will consult over the summer on the precise timing and technical arrangements for those reliefs not being abolished immediately. Details of the reliefs concerned have been published in Chapter 2 of the Budget document.

In some places I did not take forward the OTS's recommendations. In most cases this is a result of balancing simplification against the Government's wider objectives for the Budget and the tax system. I also decided to take action on some reliefs where you had recommended a more cautious approach.

The above decisions in the Budget draw a line under the OTS's work on reliefs and the Chancellor and I will not be expecting further work in this



area. However we are in no doubt that this review represents useful groundwork for future reviews by the OTS and other areas of ongoing tax policy. Overall, the changes resulting from the OTS review will mean the removal of over one hundred pages of legislation and represent a good start in the Office's work to drive simplification of the tax system.

### **Future work for the OTS**

The OTS's first reports have provided the basis for some genuine moves towards a simpler tax system. They also present some bold challenges to the status quo which I very much welcome.

To build on this excellent start, as we have discussed, the Chancellor and I would like part of the OTS's further work in the remainder of 2011/12 to involve looking at ways to improve tax administration for small business. This follows your findings that tax administration is a key source of complexity for small business and that there is scope to provide clearer communication and greater certainty in their interactions with HMRC.

I would like this report to examine closely small businesses' experience of tax administration and their contact with HMRC at key stages of their annual cycle. I would also like it to give specific consideration of the issues involved in starting and growing a new business. This work should complement the proposals for further work on small business tax that you will be putting forward. I have attached the terms of reference



for this project and look forward to your recommendations ahead of Budget 2012.

In addition we would like the OTS to develop proposals for a range of further reviews that we might consider with a view to further announcements in the summer. We would be glad to consider proposals for how we might look at wider complexities identified in your review of reliefs, the reliefs you identified for simplification, or any other areas you consider merit investigation. Proposals should also be based around the areas of complexity identified in the small business review – this report highlights a number of priorities for investigation, I would be keen to see how you propose to progress this work and to get a sense of the potential benefit for taxpayers.

Overall, the Chancellor and I are keen to consider a range of different proposals, but are particularly interested in those which you feel have the most scope to help make the tax system more convenient, simple to understand and easy to comply with.

In terms of process, we would like the OTS to present us with draft terms of reference for the proposed reviews, initial evidence of how complexity is impacting on tax payers and an outline of the main proposed activities and evidence gathering the OTS would carry out as part of the projects. As set out in the OTS framework agreement, these proposals and the arrangements for delivering them should be agreed following discussion by the OTS board.



### **Long term role of the OTS**

The first year of the OTS has reinforced the Government's view of the importance of independent scrutiny of the tax system. The next stage of OTS work will further deepen our understanding of complexity in the tax system and develop the strong evidence base the Government will need to justify reform. You have rightly identified the challenges involved but I am confident the OTS will succeed and will be looking forward to further progress over the life of this Parliament.

I would like to thank you, John Whiting, Director of the OTS and your team again for all your hard work on these first reviews.

*Yours ever  
David*

**David Gauke MP**



## OTS Small Business Tax Review

### *Improving small business' experience of the tax system*

The Office for Tax Simplification's interim report on Small Business Taxation highlighted a number of areas where the administration of the tax system could be improved to benefit small business. In particular to provide clearer communications and greater certainty

Small businesses play an important role in the British economy, and the Government wants to make it as easy as possible for them to comply with their tax obligations and minimise the administrative cost and burden of doing so.

As part of the second stage of the Small Business Tax Review, the Government is asking the Office for Tax Simplification to take forward this part of its work and produce a further report that:

- Examines and presents small businesses' experience of tax administration and their interaction with HMRC at key stages of their annual cycle, together with specific consideration of the issues involved in starting a new business.
- Documents the areas businesses find most problematic and frustrating, including an assessment of the time and costs involved
- Considers the barriers that prevent them from getting certainty in their tax affairs
- Develops a range of specific interventions to address these problems
- Considers all relevant taxes within this project

Reflecting the operational impact of any recommendations, and HMRC's shared interest in improving the administration of the tax system for small business, OTS will work closely with HMRC in developing its evidence base and recommendations. It is envisaged that OTS will commission a survey or external research to support this work, and will meet with small business and their advisers directly.

In particular, the project will focus on:

- Both the smallest businesses (particularly the unincorporated and those not represented by agents) and larger ones represented by agents, to see if different solutions are indicated.
- The end to end journey of businesses interaction with the tax system, sources of complexity and how the taxpayer experience can be made more simple
- HMRC's channels of communications with these taxpayers and their agents where they are used

- The clarity of information received by taxpayers and whether further steps could be taken to provide greater certainty
- Where there are specific points in HMRC's processes that are a source of common error or concern, and how these can best be tackled.
- The burdens associated with providing HMRC with the information required under the law

This project will form part of the OTS's final stage work on small business taxation. Recommendations will be set out in a report submitted to the Chancellor of the Exchequer ahead of Budget 2012.

These recommendations should be focussed on the administration of the tax system and should have regard to:

- HMRC's existing programmes of work to improve tax administration
- risk of non-compliance and avoidance opportunities
- requirements placed on small businesses by other parts of government and any scope to align reporting requirements
- the Spending Review resource constraints on HMRC

The evidence to support the recommendations should be quantified as far as possible, and based on:

- a wide range of survey evidence, modelling and tax payer data
- a framework and criteria for deciding how to evaluate problems and solutions
- critical analysis of feedback from tax payers and stakeholders
- comparisons with overseas tax systems
- recognition that different parts of this business population are affected in different ways