Coalition tax

General Features

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Bill Dodwell reviews the coalition government's tax policies in the last parliament

As we reach the end of the coalition government, a review of the tax policy changes over past five years can centre on six themes:

1. Taking millions of people out of income tax by increasing the personal allowance from £6,475 inherited in 2010/11 to £10,600 for 2015/16.
2. Cutting the main rate of corporation tax from 28% in 2010 to 20% in 2015 and reducing the small profits rate from 21% to 20% (from 2011). This policy should be linked with the one on capital allowances – where the main rate of writing down allowance was reduced from 20% to 18% from 2012 and the special rate cut from 10% to 8%. Short life elections for assets with lives up to eight years were introduced in 2011 and the annual investment allowance was cut from £100,000 in 2010 to £25,000 for nine months in 2012, before being increased to £250,000 from 1 January 2013 and then £500,000 for April 2014 to December 2015.
3. New investment in innovation and the creative industries through the introduction of the patent box; the transformation of R&D tax credits into an expenditure credit, with cash payments to loss-making companies, and a whole succession of incentives for high-end television, animation, video gaming and orchestras. All the incentives are focused on bringing jobs to the UK, or supporting those already here.
4. Liberalising the treatment of savings through the new pension fund freedoms, the broadening of the ISA regime (allowing funds to be switched freely between cash and stock market investments), the 50% increase in the ISA limit to £15,240 and the introduction of the ability for spouses to inherit an ISA. At the same time, it has raised significant sums through large cuts to the lifetime and annual pension contribution allowances – from £1.8 million to £1 million in 2016 for the former, and from £255,000 to £40,000 for the latter.
5. Significant changes to the taxation of non-residents – who have new taxes on residential property – and non-domiciled individuals who bear increased levies to remain within the remittance basis for non-UK income and gains.
6. Major changes to the UK anti-avoidance regime. Every government tackles perceived tax avoidance; the coalition made two huge structural changes by introducing the general anti-abuse rule from July 2013 and the accelerated payments regime from July 2014.

The ambition of a £10,000 personal allowance came from the Liberal Democrats, but it was seized enthusiastically by their Conservative partners. The huge increase in the personal allowance is massively expensive – something like £500 million for each £100 increase. Inflation would probably have taken the allowance to some £7,200, so a jump in a single year would have cost £16 billion. In fact, spreading the increases over five years has added to the cost but made it much harder to track through the Red Book accounts. We now have the not entirely welcome situation where the Treasury estimates that some 43% of adults do not pay income tax. Former Chancellor Lord Lawson has spoken of his concern that voters should have a stake in the tax and spending system, as he puts it. There has been the rapid increase in the numbers subject to higher rate tax, as the threshold has been reduced, or at least not increased in line with inflation, to focus the benefit on basic rate taxpayers. In 2010, some 10% of taxpayers paid higher rate tax; today it is about 18%.There's also an interesting effect on those moving on to the new universal credit. This is set on a post-tax basis, so those receiving the benefit keep much less of the personal allowance increase than those on the older tax credit system, or those not receiving credits at all. Unsurprisingly, since the recession ended there has been considerable debate over who has received the benefit; distributional analysis from the Treasury indicates that middle-income households have lost little from the many tax changes, including the large rise in the VAT rate. They can thank the personal allowance policy.

The second item on the list – corporate tax reform – made good use of a 'road map', where the government set out its intentions early on and companies could easily see the direction of travel. The rate cut costs some £800 million – 1 billion per 1% – so an annual cost of something like £8 billion now that the 20% goal has been achieved. Part of this cost has been funded by reducing capital allowances, much as the previous Labour government did when it reduced the corporation tax rate from 30% to 28%. Governments still account in cash, so both items go together. Cash is also important for businesses, but they do accruals accounting so they see the profit and loss account benefit of the rate cut. However, the capital allowances are spread over a longer period, with a modest financing cost. The question is whether the UK will recoup the cost of the corporation tax cut. Economic models indicate that more business will flow to the country with the lower tax rate, thereby boosting employment and, in the long run, the corporation tax take. We have seen a number of multinationals move operations to the UK, responding to this positive incentive. But the issue has been masked by some companies moving headquarters to the UK, with fewer jobs and not much corporation tax. Despite this, headquarter activities are welcome since they can bring benefits over time. Headquarters do however purchase many services – from banking to auditing, from advertinsing to legal advice – so the UK's strong service sector is likely to see an indirect benefit. Companies that are simply incorporated or tax-resident here bring rather less.

The innovation incentives cost relatively little to offer. But only by offering incentives in sectors where the UK already has a presence is benefit obtained from the clustering effect and the use by overseas multinationals of UK facilities and expertise.

The growth of the UK film industry has definitely been aided by film tax credits.

The first moves in the savings area were to increase tax. It seemed quite extraordinary that the 2006 pension reform offered individuals annual tax deductions of up to £255,000. The small group of people with earnings above this level took full advantage of Exchequer generosity, so the cost rocketed. We thus saw the annual allowance cut first to £50,000 and then to £40,000, combined with cuts to the lifetime allowance – affecting those earning over something like £80,000.

The new system has introduced significant inequalities between those in defined contribution pensions and those (mainly public sector) employees in defined benefit schemes, who are noticeably less affected. The Chancellor then sprung a huge surprise at the 2014 Budget when he announced significant liberalisation to the access that individuals could have to their pension funds, once they had turned 55. It seems highly likely that some will start to draw out money from their accumulated funds from April 2015, paying income tax at their marginal rate. Large tax receipts have been built into the Red Book accounts – thus achieving the virtuous goal of receiving money while offering a benefit that many people want.

ISAs have also been set free so that investors can switch freely between cash and stocks and shares – and even take money out and replenish it in the same tax year without affecting the tax-exempt status. Spouses may also inherit a special ISA allowance equal to the market value of ISA funds held by the deceased and left to the spouse. Higher rate taxpayers now have choices over where to invest funds for retirement – in the flexible but post-tax ISA, or in the scaled-back pension system with free access to the fund from age 55.

The coalition needed to deal with some aggressive tax avoidance, which was out of control. There are two game-changers here.

Accelerated payment notices and follower notices remove the cash-flow benefit of entering into a scheme, which will surely mean the end of personal loss planning. Investors would need to be unreasonably confident of the success of a scheme if they now consider investing, paying a promoter a large fee up-front and then waiting at least five years before getting a tax refund. Disclosures by promoters to HMRC under the tax disclosure rules have almost completely dried up; the market has gone.

The introduction in July 2013 of a general anti-abuse rule also plays a part. Although some politicians complain that they've not seen a case, practitioners know that it has cut out attempts to find loopholes in our legislation. It is another contributor to the substantially reduced number of tax schemes.

The coalition has surely bequeathed an impressive legacy to the country and the next government. After these major reforms, perhaps it might be time for less change – although multinationals know they must look forward to the implementation of the G20/OECD BEPS project. Instead, the focus should turn to HMRC's delivery of the digital agenda.