Tax thresholds and ceilings – the numbers game

In 2010, the Office of Tax Simplification carried out its review into tax reliefs, and produced a list of all 1,042 reliefs and allowances. As we read through the tax legislation to find the reliefs, we also noticed a large number of specific monetary values, some of which had not been changed for many years. Well known examples are the £8,500 taxable benefits threshold for "higher paid" employees (last increased in 1979), or the £3,000 inheritance tax annual exemption for gifts which was last updated in 1981[1].

We thought it would be a useful exercise to list all these numerical values, thresholds and ceilings and see if there were any patterns or common themes, and also whether we could draw out any lessons for tax simplification. Thresholds have the potential to make a useful and significant contribution to tax simplification by excluding low-value transactions and some taxpayers from having to be considered by the tax system.

This is not a formal OTS project, and we are not making any recommendations to the Government as a result. It should instead be seen as a contribution to the wider work the OTS is carrying out on complexity. In this regard, it operates in a similar way to our April 2012 paper on the length of tax legislation[2].

How we drew up the list

At an early stage of our review, one of the OTS Board members, Adam Broke, told us a similar review had been done in 1977 by Halmer Hudson, resulting in an article in the British Tax Review. We found the article[3], which listed 162 numerical thresholds and ceilings across direct taxation. The article also looked at the age profile of these numbers, and how many times they had been updated.

We took a similar approach, but decided to look at all the taxes administered by HMRC, direct and indirect, including national insurance. We also thought we should not just simply list all the numbers, but try and trace them back to the first Finance Act they were mentioned in, and identify any subsequent changes. This turned out to be quite an exercise in detection, and we relied heavily on the very useful footnotes in the Tolley's yellow and orange books, and the CCH purple books. We are also extremely grateful to the HMRC library and the Bodleian library for giving us access to original Finance Acts and the 1842, 1918, 1952 and 1970 consolidated Taxes Acts.

The full list of thresholds, ceilings and other monetary amounts is set out in the detailed spreadsheet on the OTS website.

Where the numbers have their origin in non-statutory material such as old Inland Revenue extra-statutory concessions, we did not attempt to establish their age prior to

[1] The exemption was introduced for capital transfer tax, which was renamed inheritance tax in 1986.
[2] http://www.hm-treasury.gov.uk/d/ots_length_legislation_paper.pdf
[3] The Scope for Indexation, British Tax Review 1977 No 4, page 195

their appearance in legislation. Nor did we look at secondary legislation (statutory instruments), though we did of course consider amendments made to primary legislation. Similarly, we did not consider non-statutory allowances and thresholds. We have tried to make the list as accurate as possible, but if there are any mistakes or missing figures, please let us know.

We used the retail price index (RPI) data published by the Office of National Statistics to estimate what the numbers would be in October 2012 if they had kept pace with inflation, although we realise that statisticians differ on the suitability of RPI data.

Our findings

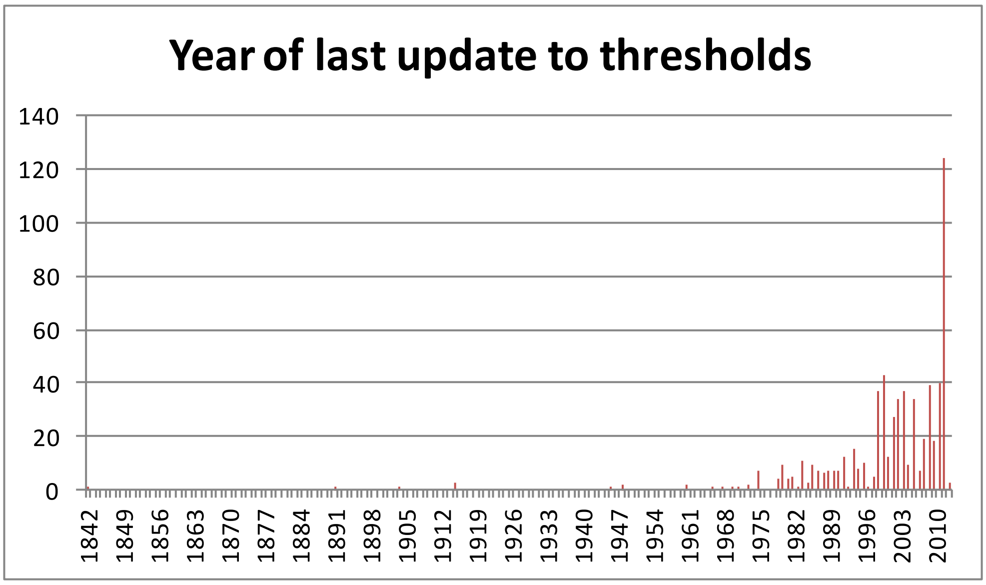
We found 639 specific monetary values in tax legislation as at October 2012. Of these 425 are thresholds and 214 relate to penalties. The smallest is £0.00059, being the climate change levy rate per kWh for gas supply in Northern Ireland. The largest is £20 billion, the threshold for the bank levy. By comparison, in 1977 Mr Hudson found the smallest figure to be £1 and the largest was £250,000 (leaving aside the £50 million restriction on losses for oil companies).

There are 198 different numerical values, as set out in the detailed spreadsheet. Thresholds offer the greater opportunity for contributing to simplification; penalties cannot be ignored as a plethora of penalties are a source of complexity on their own (although this is not likely be an issue for the majority of taxpayers) . The most common amounts used are, unsurprisingly, the whole thousands or hundreds which are used for penalties: £3,000 (54 times), £100 (40 times) £1,000 and £300 (36 and 35, respectively). 123 numerical values are used just once.

The oldest unchanged figure we found is in section 106 of the Taxes Management Act 1970. This imposes a flat rate penalty of £50 for refusing to deduct tax at source from annual payments. The same £50 penalty also appears in section 103 of the 1842 Income Tax Act. If the penalty had kept pace with inflation, it would now be around £4,800.

The oldest unchanged tax allowance is the income tax exemption for unregistered friendly societies for the first £160 of annual income. This was introduced in the 1904 Finance Act, and was the same as the £160 general exemption from income tax at the time, the precursor to today’s personal allowance. It was introduced to make sure that unregistered friendly societies qualified for the general allowance then in force. But no-one seems to have updated the £160 since 1904, and for a long time it was faithfully reproduced (until recently) in section 459 of the 1988 Income and Corporation Taxes Act. There was a recent HMRC consultation on the taxation of friendly societies, but this didn’t alter the £160 exemption, which is now in section 171 of the 2012 Finance Act.

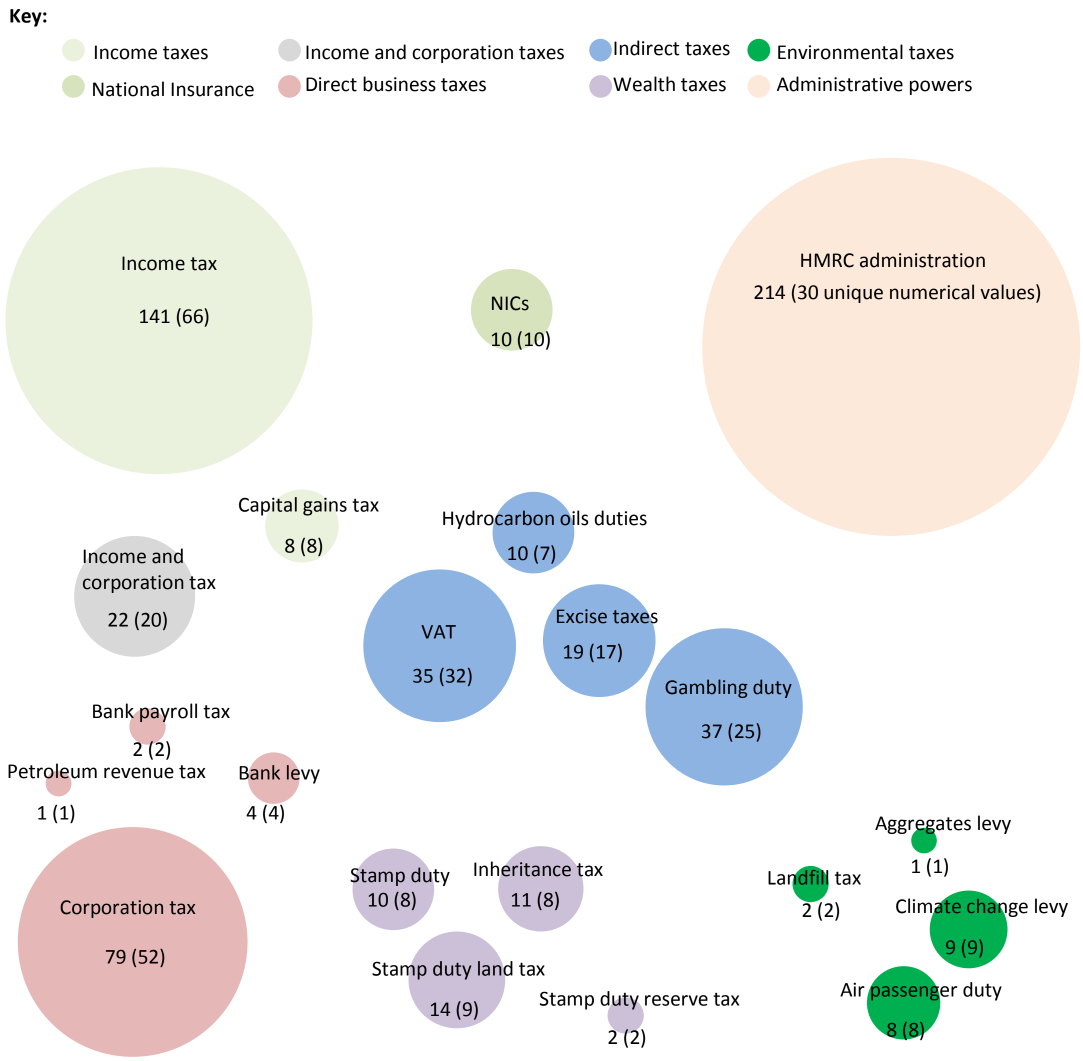
The chart below sets out the age profile of the 639 numerical values. Of the 170 years to have passed since 1842 (the oldest threshold still in existence) there are 49 individual years which are associated with at least one current threshold. A large number of thresholds were last updated in the 2000s and in many cases this will be when they were in fact first introduced. Whilst some thresholds have not been updated for more than 50 years these are perhaps viewed as historically interesting rather than having a great impact on taxpayers. It is probably some of those which have not been updated for between 10 and 50 years which will be more relevant to the taxpayers of today.



We also looked at how frequently the monetary amounts changed over time. Some of them can be updated by statutory instruments. Others have no specific legal provision for updating, so any changes need to be in a Finance Act. Some important reliefs, such as the personal allowance for income tax, or the blind person's allowance are automatically increased by inflation, unless the Government decides otherwise. Recently, the basis for increasing many (but not all) of these allowances was changed from RPI to CPI.

Some amounts are changed almost every year, such as the personal allowance for income tax and the VAT threshold. Others seem to have been regularly updated initially but then frozen for many years – for example, the small profits threshold for corporation tax has been £300,000 since 1994, but changed 12 times between 1975 and 1994. Or take the threshold for taxing benefits for higher paid employees, currently £8,500. This can be traced back to a £2,000 threshold for taxing benefits in kind introduced in the 1948 Finance Act, and left the same until 1974 when it was increased to £5,000. There were two further increases – to £7,500 in 1978 and £8,500 in 1979, after which it has stayed the same for 33 years.

The diagram below illustrates the number of thresholds for each of the main taxes and penalty regimes.



<u>Penalties</u>

Of the 639 specific numbers, 214 are numerical penalties, ranging from a £1 flat rate stamp duty penalty to a maximum penalty of £5 million for tobacco smuggling. The recently-concluded HMRC Powers Review managed to consolidate many of the penalties across direct and indirect taxes, with initial penalties for various missed deadlines of £300, daily penalties of up to £60 and penalties for poor record keeping of up to £3,000. But there are still many initial penalties of £100, £200 and £250 and daily penalties of £5, £10, £20 and £40. There are flat rate penalties of £5,000 for failures to comply with the rules for Senior Accountable Officers for large companies, and also for failure to notify HMRC of tax avoidance schemes (which can be increased to £1 million if £5,000 "appears inappropriately low"). There is a flat rate penalty of £10,000 for failure to appoint a UK tax representative for the purposes of the aggregates levy.

HMRC issued a consultation on simplifying regulatory penalties in June 2011, and published a response document in June 2012. The response document set out the Government's view that "the benefits of simplification were not enough to justify the costs of major reform". Instead, HMRC would consider a housekeeping option to legislate for a new power to revalorise fixed penalties and abolish those which are obsolete or no longer used. However, the issue was not considered pressing enough for the 2013 Finance Bill, but would be left until “an appropriate opportunity”.

Lessons for tax simplification

If you need to draw a dividing line somewhere in the tax system then there are several options for policy makers. You can use a word or term and give it a detailed legislative definition, for example “plant or machinery”. You can use a common word and leave the Courts to interpret it, for example “income”. Or you can use a word that has an existing legal definition, for example “partnership”. The difficulty in using words is that they are open to interpretation. That is not the case with numbers. Numbers are easily understood, remembered and applied by people and are easily incorporated in computer systems. It is difficult to think of a simpler way of designing boundaries between different parts of the tax system. There is no subjective judgement involved in deciding which side of a numerical boundary you fall, unlike other boundaries that rely on words or legal concepts[4].

Numerical tax thresholds and ceilings can be a great simplification. They serve to bring people and businesses out of the tax net altogether – examples being the personal allowance or the VAT threshold. They are a very useful tool for policy makers, being used to deliver policy objectives such as a progressive tax system, to fine tune the money raised by the tax system, to target anti-avoidance rules at the riskiest cases, or to target tax reliefs where they will have greatest benefit. Also, and more controversially, leaving a numerical value alone can be a relatively painless way for Governments to raise extra tax revenue.

Inflation

However, there are downsides to using numerical amounts in legislation. The most obvious is the effect of inflation. Inflation changes the value of a monetary amount over time, so that the original policy choice of the amount may no longer be optimum. That does not mean to say that all numerical amounts need to be updated by inflation each year. For one thing, frequent change is itself a major cause of tax complexity. If numerical values change every year, it is difficult to remember them, particularly for tax practitioners or HMRC staff who deal with many customers. For businesses with accounting periods that straddle a change, it might be necessary to apportion figures between tax years and carry out two separate tax computations rather than one. Also, changing all 639 numerical values every year would clog up valuable Finance Act space and would cost HMRC and legal publishers a lot of money to keep their guidance up to date.

An interesting question is whether there is an optimum period after which numerical values should be reviewed by Government. For the reasons stated above, doing this every year for every amount is impractical, but it is entirely reasonable to review a small number of key figures annually – as happens now with personal allowances in particular. For other amounts, the frequency of review should logically depend on the

[4] Fixed amounts do raise question of fairness as they do not, for example, relate to ability to pay, but fairness is a separate question and beyond the scope of this paper.

rate of inflation. In a time of low inflation, it takes longer for the value of the amount to drift significantly from the optimum.

The following table illustrates the effect of inflation on a penalty of £1,000 with rates of inflation of 2%, 5% and 10%:

Inflation rate	**2%**	**5%**	**10%**
Initial value	1,000	1,000	1,000
Real value after 5 years	904	774	590
Real value after 10 years	817	599	349
Real value after 15 years	739	463	205
Real value after 20 years	668	358	122

One way of setting a time limit for reviewing a monetary value might be to carry out a review after the value has changed by a set percentage, eg 20%. In this case, you should review the figure after the following periods:

2% inflation rate: 12 years
5% inflation rate: 5 years
10% inflation rate: 3 years

With RPI inflation currently around 3%, this approach suggests reviewing thresholds every 8 to 10 years.

One result of inflationary adjustments is that thresholds can end up as rather odd numbers[5]. There is a good argument for thresholds being round numbers where possible – more memorable and easier to use.

<u>Distortions caused by numerical thresholds</u>

Numerical thresholds distort economic behaviour. This is inevitable if different tax treatments apply either side of a boundary, creating an incentive for people to artificially place themselves on the more favourable side of the boundary. A classic example is the VAT threshold, which deters some businesses from expanding beyond the threshold so as to avoid the extra burden and cost of operating VAT. Another is the various Stamp Duty Land Tax limits which promote ‘bunching’ of sale prices at or just below the thresholds (and indeed actively encouraged avoidance).

The distortionary effect of numerical boundaries can be minimised by designing the difference in tax treatment either side of the boundary so that the cost of artificially placing oneself on the more favourable side outweighs the tax advantage. One way of doing this is to introduce tapering so that the tax increase on one side of the boundary does not all come in at once. However, this tapering is always at the expense of simplicity and needs to be used with care. Another is to impose a regulatory cost or charge for moving from one side to the other, for example some countries impose a relatively high minimum amount of share capital for setting up companies.

[5] Such as the current £8,105 personal allowance….why not £8,100?

Another way of minimising the artificial behaviour caused by a numerical boundary is to set the boundary where it aligns with common sense. This makes it more acceptable for the taxpayer, and behavioural research suggests compliance is likely to be better. However, although a boundary may be aligned with common sense when it is set, this can change over time to the extent that the original policy purpose is completely lost.

Possible simplifications

It would clearly be a big job to tackle all 639 thresholds and ceilings at once, analysing whether they should be left alone, updated or abolished. At a time when HMRC is facing exceptional cost pressures, it is probably not a priority task either. But it might be possible to draw up a priority list of which thresholds should be looked at first.

Maybe it shouldn't be the 1842 penalty, because it is unlikely to ever really affect anyone, and in a way it would be a shame to lose this final link to the 1842 Act. On the other hand there are obvious candidates for priority review, that affect a lot of people and are many years out of date. Some have been mentioned in this article. Others will be obvious from the spreadsheet.

However, the OTS has no remit to make specific recommendations on this at the moment, and we would welcome comments or debate on the issues this paper has raised. Depending on comments received and the general reaction to this paper, it may be appropriate to develop a formal report with recommendations.

Any comments should be directed to ots@ots.gsi.gov.uk

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