Taxpayer Response to the Recent "Flat Tax" U.K. Capital Gains Tax (CGT) Reform and the Implication for Tax Law Simplification

Peter Jelfs, Mazars LLP,
and Andrew Lymer, University of Birmingham

All parties with an interest in United Kingdom tax law can apparently agree on one thing: it is complex. Surveys show that the U.K. tax code is now the longest in the world, having recently overtaken India to claim that dubious title. It is equally the case that the amount, as well as the complexity of the legislation, increases every year. Given this situation, and the fact that increasing complexity leads to increasing compliance and administration costs, it is at first sight puzzling that none of these interested parties makes any concerted effort to reverse the trend. The recently attempted capital gain tax (CGT) reforms in the U.K. may offer some clues to this apparent dichotomy.

U.K. Tax Legislation

The U.K.'s tax legislation primarily consists of a number of Parliamentary Acts and delegated legislation in the form of Statutory Instruments. Finance Acts are passed at least once a year, introducing new legislation and updating or repealing old law. Other Acts are passed as the need arises. Statutory Instruments are introduced throughout the year to enable continual updating of the tax legislation.

Laws relevant to all taxes are often grouped together in book format for use by tax professionals, one of the classic reference works being Tolley's Tax "Yellow and Orange" handbooks. Aside from the primary and secondary legislation, the handbooks also contain a large amount of material produced by HMRC to provide their interpretation of the law, including:

- Extrastatutory concessions
- E.C. material
- Statements of practice
- Press releases
- Other nonstatutory material

In addition, there are judgements from tax cases which are usually not included in the handbooks but with which a tax practitioner would be expected to be familiar. Some of these decisions will ultimately be incorporated into the legislation.

Lord Wedderburn in his book, *"The Worker and the Law,"* commented "Most people want nothing more from the law than that it should leave them alone." However, this is hardly possible with tax law, which is one of the few branches of law to touch the lives of almost everyone.

The Making of Tax Law

The making of tax law follows an established procedure and usually starts from an initiative from one of the government's executive branches, such as Her Majesty's Revenue and Customs (HMRC) or HM Treasury. There is no statutory requirement for consultation before a Bill is drawn up, although informal discussions with interested parties often occur.

Parliament has no formal role in generating or consulting on proposals until the publication of the Finance Bill, when it is considered by Members of Parliament (MPs) on the Finance Bill Committee. Given the technical nature of the Bill, MPs often rely on interpretation provided by external bodies. The Committee only sits for about 6 weeks due to the time constraints in passing the legislation through Parliament. Backbench MPs are often encouraged not to delay the process, and the House of Lords has no scrutiny role of the Finance Bills.

Complexity of the U.K.'s Tax Legislation

Commentators appear to be unanimous that the U.K.'s tax legislation is complicated. Martin (2005a) is typical when he states that the U.K. tax legislation is "lengthy and intricate but is usually drafted in a dense style that makes it inaccessible to the layman." In a similar vein, Vann describes lengthy tax legislation as "tax rule madness."

History of Tax Complexity

The complaint that the U.K.'s tax legislation is too complex is not new. In 1853, MPs urged William Gladstone, then Chancellor of the Exchequer, to

see that income tax legislation was made intelligible even to those without a legal education. He replied:

> "To bring the construction of these laws within the reach of [everyone is] no doubt extremely desirable, but far from being easy ... The nature of property ... and its very complicated forms [render] it almost impossible to deal with it for the purpose of the income tax in a very simple manner."

By 1981, the Presiding Special Commissioner referred to Gladstone when he said, "The plea today is that it would be some advance if laws of this kind were intelligible to those who *have* received a legal education."

Very similar comments have also been made in the U.S. The 1927 Report of the Joint Committee on Internal Revenue Taxation stated, "It must be recognised that while a degree of simplification is possible, a simple income tax for businesses is not."

Both quotations recognize that tax itself is an inherently complex subject. So, it should come as little surprise that tax legislation is also complex.

Reasons for Complexity

Complexity can arise simply from increasing length as the more pages in the tax legislation, the less likely it is that an individual can be familiar and feel comfortable with all of its provisions. On first principles, tax law increases in length due to new tax law enactments each year exceeding the amount of material repealed. Martin (2005) notes that this is in part due to government introducing political policy measures with little pressure or incentive to reform ineffective legislation or to try to simplify the legislation. In his opinion, these have been introduced piecemeal over a long period with little regard to principles which could have created a simple, coherent system.

Complexity can also arise from the language used. The language may be difficult to understand or stylistically poorly drafted. The Tax Law Rewrite project, discussed in detail below, set out to simplify the language of the legislation, but its effectiveness is being called into question.

Martin (2005a) also notes the unique nature of tax law compared to other law in that its primary purpose is not to help taxpayers. As a result, criticism that it can harm business through its complexity can be deflected.

Other Relevant Factors

A number of other factors have been identified as leading to complexity in tax legislation. Some of these were identified by Martin (2005) from a U.K. perspective and Gale (2001) from the U.S.

1) Conflict between policy goals

Gale (2001) states that most people agree that taxes should be simple, fair, conducive to economic prosperity, and enforceable, but cannot agree on the relative importance of each goal. When governments implement policy, it will therefore represent a balance between the goals, and legislative complexity is a consequence of trying to achieve this.

It is well-known that more equitable or fairer taxes usually conflict with tax simplification. Tax burdens are often tailored via legislation to the circumstances of individuals, improving equity but increasing overall complexity of the tax system by increasing the length and complexity of the legislation. In addition, tax rates that vary with individual characteristics create opportunities for tax planning and avoidance, which may in turn require the passing of antiavoidance legislation.

2) Fiscal incentives

Successive governments have shown a desire to promote or discourage certain types of behavior among taxpayers by providing tax or fiscal incentives. However, these targeted subsidies often increase complexity by creating more distinctions between taxpayers and sources or uses of income.

Academic literature has widely analyzed this area and generally concluded that acting in a particular way for tax reasons impairs economic efficiency, distorting the market and giving rise to costs known as the "excess burden of taxation," which arises from actions that would not otherwise have been performed.

In general, taxes with a wide base are less distorting and more efficient than those with a narrow base. In some situations, the market is inefficient, an example being a polluter maximizing profits while imposing remediation costs on the community. Governments often use tax as a policy instrument to discourage such behavior, or to encourage actions thought to benefit the community, such as enhanced tax relief for research and development expenditure.

Martin (2005a) considers incentives based on this premise to be likely to produce unsatisfactory results, along with situations where the basis for providing incentives is unclear in itself, giving examples of incentives introduced and subsequently withdrawn, such as profit-related pay and the business expansion scheme, both victims of unwanted tax avoidance schemes. Expanding on his observations, it is evident that, in order to prevent such abuse, special reliefs become so full of conditions or require such extensive redrafting that they greatly add to the complexity of tax legislation.

3) Prevention of tax avoidance

Tax avoidance is the arrangement of one's affairs to pay the minimum amount of tax, as spelled out by Lord Tomlin in the well-known case of *Duke of Westminster vs. CIR:* "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be … However unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax." It is within the letter, if not always the spirit, of the law, unlike tax evasion.

As the U.K.'s tax legislation has grown more complex, tax advisers have increasingly exploited loopholes to create complex avoidance schemes. Loopholes are often created by the specific statutory language, and HMRC is highly likely to challenge any such scheme in the courts. Where the taxpayer is successful, government will act to reduce revenue loss in areas where significant avoidance occurs. Taxpayers and their advisers will then seek new opportunities for avoidance. This creates a cycle of increased complexity in both tax laws and avoidance strategies.

Some commentators hold the view that tax advisers are responsible for the generation of such legislation by the avoidance schemes they devise and promote to business. Others consider the role of legislators who have added successive layers of antiavoidance legislation by "tinkering" with the system to be more significant. One such example identified by PwC and the World Bank (2006) was of a single transaction of borrowing in the U.K., which may require up to six sections of antiavoidance legislation or case law to be considered before treatment for tax purposes may be ascertained, namely:

- s209 ICTA 1988—whether interest is dependent on the results of the business and hence a distribution
- p13 Sch9A FA1996—loans for unallowable purposes
- Sch28AA ICTA 1988—thin capitalization and transfer pricing
- s24-31 & Sch3 FA(no.2) 2005—antiarbitrage provisions
- s349 ICTA 1988 and SI 1970/488—treaty clearance from U.K. 20-percent withholding tax
- relevant case law, e.g., *WT Ramsay*, *Furniss vs. Dawson*

Possibly the most common form of avoidance is the manipulation of tax affairs to take advantage of other provisions of tax law. The more tax law in existence, the more such opportunities exist. New tax law presents new opportunities to move profits to a lower rate of tax. This may involve artificial steps or even lead to tax evasion. Antiavoidance legislation is required to prevent such schemes from succeeding, but is usually particularly complex and obscure as a result of the complex nature of its target.

In the past, legislation to block such schemes was passed on an individual scheme basis. More recently, HMRC has tried to move toward "principle-based" antiavoidance legislation, such as the recent "disguised interest" legislation. It is designed to repeal piecemeal legislation by identifying the avoidance principle at stake, removing length and complexity from the legislation. However, such legislation is proving very difficult to draft satisfactorily, throwing into question whether the predicted benefits will ever materialize.

A piece of research carried out on behalf of the Tax Justice Network (2007) looked at the purpose of all 1,503 pages of the Finance Acts from 2004 to 2006. While the purpose of legislation is often open to debate, the report nonetheless shows the importance of antiavoidance provisions in adding length to the legislation. It found that 48 pages dealt with routine issues like tax rates, 841 were government-driven initiatives, and 614 (41 percent) were antiavoidance measures.

4) Tax Law Rewrite project

The Tax Law Rewrite project was initiated to rewrite tax law in plain, modern English but without changing the underlying law. However, the implication that the project is meant to reduce the overall complexity of the tax legislation is probably misplaced. Simplification was not a remit of the project as the rewritten Acts had to be fast-tracked through Parliament. Even

so, some of the new wording does amount to a change in tax law which may have repercussions.

PwC and the World Bank (2006) claim that the project is responsible for a 50-percent increase in length of the rewritten provisions and note that, at the date of the report, less than half of U.K. tax law had been rewritten. Other criticisms of the usefulness of the project have included the fact that the general public is unlikely to want to read tax law regardless of the language's clarity, and that many tax professionals were content with the old terminology which had been defined by the courts.

In 1995, Avery Jones (subsequent chairman of the IFS Tax Law Review Committee) commented concerning the new Tax Law Rewrite project, "My real objection to rewriting is that I do not find much of a connection between the causes [of complexity] and the proposed solution. The solution seems to me to be an implied acceptance that nothing can be done to remove the real causes of complexity which are deeply rooted in our whole legal culture."

This observation was largely proved in that, as Gammie (2007) states, "Expressing concepts in plain English does nothing to simplify the concepts themselves … complexity of language has been replaced by the complexity of legislative volume as more words (albeit simpler ones) have been required to retain precision." The worth of the project remains a subject for keen debate.

Effects of Tax Complexity and Responses

Tax legislation in both the U.K. and the United States continues to increase in length. By 2008, Tolley's Yellow Tax Handbook, containing the U.K. primary and secondary direct tax legislation, could only be fitted on to 10,134 pages by using a smaller format text than the previous year, up from 5,952 pages as recently as 2001.

Truman's case study into the effect of Finance Act 2008 on the length of the U.K. tax legislation revealed the following:

- Abolition of taper relief removed between 8,000 and 9,000 words, but these remain in Tolley's Yellow Tax Handbook to enable taxpayers to calculate their liability in future years, giving the illusion of failure to simplify.

- The introduction of entrepreneurs' relief to appease the outcry from taxpayers and advisers over the abolition of taper relief will add back about half of the words removed above.
- The changes in residence and domicile laws will add about 5,000 words to the legislation.
- Income-shifting provisions of 700 words provide a good example of the worst kind of "legislation by guidance." The legislation is vague and wide-reaching and required over 9,000 words of interpretative guidance.
- The major causes of extra legislation often concern a very small number of taxpayers, such as antiavoidance legislation for insurance companies.

Truman describes the efforts to reduce legislative complexity as "a rout" and repeats his suggestion from the 2007 Hardman Lecture that government needs to set a target of legislative reduction within a certain number of years for any realistic hope of simplification occurring. He acknowledges that his suggestions of a 25-percent reduction in length within 5 years currently show little sign of being achieved.

Taxpayer Desire for Simplification

PwC and the World Bank (2006) highlight the unfavorable consequences of large volumes of legislation making it impossible for tax advisers in industry or practice to read or understand all relevant legislation and having to rely on more specialists, including those at HMRC. As a result, large to medium companies may have to make a decision whether obtaining tax advice is of benefit using a cost/benefit analysis.

Their report concludes that increasing complexity probably leads to lower international competitiveness, and voluminous legislation reaches a point where the level of compliance drops through ignorance rather than evasion. As a result, business leaders and their representatives often make public their concerns over the complexity of tax legislation and the negative effect this has on running their business, chiefly the time and cost of compliance, both of which increase with increasing complexity.

One such study was the Tenon Forum Think Tank's 2005 report which interviewed directors of small and medium-sized businesses in the

U.K. 77 percent claimed the U.K. tax system was too complicated, and 73 percent wanted a flat rate tax scheme. The Think Tank was divided on whether this was a plea for simplification, as some members felt that lack of understanding of a flat tax meant it was incorrectly being positioned as a solution to complexity. They also raised the issue that a simple tax system could easily become complicated very quickly, and this size of company often benefits from targeted exemptions, a classic source of legislative complexity. However, the message from the study was apparently clear in that U.K. businesses want simplification of the tax system and legislation, although, as discussed below with the recent CGT reforms, apparently not at the expense of potentially higher rates of tax.

Government's Inability to Reduce Complexity

While successive U.K. governments have often expressed their desire to reduce complexity of the tax legislation, the trend is inexorably toward greater length and complexity.

Gale (2001) points out that the simplest tax system would be a consumption tax at a flat rate with universal deductions, exemptions, and credits and withheld at source. However, the U.K. system bears no resemblance to this model as a progressive income tax with targeted exemptions and withholding for a small number of income types.

Simplification of the U.K. tax system remains a prominent topic, and leading figures still pronounce on the subject. The incoming 2008 President of the Chartered Institute of Taxation (CIOT) highlighted it as one of the themes of his presidential year, and the government reaffirmed its "commitment to tax simplification" at various times, including the 2007 Prebudget Report. The new Chancellor of the Exchequer, in his first speech in July 2007, stated, "We must continue to simplify the tax system wherever we can." Continuation of a process, however, implies that it has already started, and there is little evidence of simplification occurring before or after his speech.

Indeed, government pronouncements on the issue have a long history. Even after the first Income Tax Act of 1799, the 152 pages of the Act were proving sufficiently complex for the government to publish a guide entitled "A Plain Short and Easy Description of the Different Clauses of the Income Tax so as To Render it Familiar to the Meanest Capacity."

Difficulties in Comparing and Measuring Complexity

Apart from the difficulty of defining the concept of legislative complexity, it is not a simple matter to attempt to measure it, given the lack of obvious comparisons. Comparison with the current system appears on first principles to be a reasonable choice.

A study performed by PwC LLP and the World Bank (Paying Taxes—The Global Picture, 2006) compared the GDP of a number of countries with their tax administration burdens, as measured by the number of pages of primary federal tax legislation. The results are shown below:

Country	GDP ranking	GDP $m	Number of pages (ranking)
U.S.	1	11,711,834	5,100(5)
Japan	2	4,622,771	7,200(4)
Germany	3	2,740,551	1,700(10)
U.K.	4	2,124,385	8,300(2)
France	5	2,046,646	1,300(13)
China and Hong Kong	6	1,931,710	2,000(9)
Italy	7	1,677,834	3,500(7)
Spain	8	1,039,927	530(17)
Canada	9	977,968	2,440(8)
India	10	691,163	9,000(1)
Korea	11	679,674	4,760(6)
Mexico	12	676,497	1,600(12)
Australia	13	637,327	7,750(3)
Brazil	14	603,973	500(18)
Russia	15	581,447	700(=15)
Netherlands	16	578,979	1,640(11)
Switzerland	17	357,542	300(20)
Belgium	18	352,312	830(14)
Sweden	19	346,412	700(=15)
Turkey	20	302,786	350(19)

The report acknowledges that certain countries levy taxes at state and local levels. In these cases, the number of pages data above are likely to be severely understated.

The authors make two key conclusions: the volume of a country's primary federal tax legislation is not directly proportional to its economic size, and the volume of legislation is increasing. It is generally accepted that the U.K.'s tax legislation is now the longest in the world, having overtaken India since the report was published. So, on a first viewing, it might seem that the U.K. has a disproportionately complex and lengthy tax legislation.

However, in a later study, the authors claimed that this work was only intended to stimulate debate and not to represent an accurate comparison of

complexity. Factors such as print size were not taken into account, which, taken with the possible understatement mentioned above, casts considerable doubt on the usefulness of the above data as a comparison study. It is somewhat surprising that the results of this study were not linked to those of another by the same authors comparing compliance times for a range of countries to see if any connection with the length of legislation existed.

Tax Law Simplification Strategies

Strategies other than "flat tax" are regularly put forward to attempt to reverse the growth of the tax legislation's complexity. However, only simplifying the language of tax law will not address the underlying complexity, which arises from different demands made of the tax system and the constraints under which it operates.

The 1994 Tax Law Review Committee's final report listed three types of complexity—linguistic, policy, and compliance—which would all need addressing by comprehensive reform. It also stated, "Without policy changes, the benefits from rewriting tax legislation are limited." Similar sentiments were expressed by the Tax Law Improvement Project in Australia.

Martin (2005) considers that three-quarters or more of tax law could be removed with a commitment to simplification. The principles behind this strategy would include:

- Refocusing on the primary objective of direct tax to identify and tax profit, using accounting profit as the starting point for calculating taxable profit. Any departures from accounting profits should only made with reference to clear principles. All profits would be taxed in the same way and the schedular system abolished.
- The approach should be purposive, with detailed rules replaced with statements of underlying principles, and backed up by wider use of rulings from HMRC both before and after the transaction.
- Reviewing to ensure all parts fit coherently, including combining and aligning tax rules currently used in different situations.

Martin (2005) considers that simplification is possible given political will, although he acknowledges that not everyone is so optimistic, pointing to failed simplification programs in Australia and New Zealand. Efforts to this end should be appreciated as long as the sense

of direction was clear, although both taxpayer and government could lose out under individual simplification proposals. He notes that a number of sections of tax law would have to remain, such as group relief, to prevent companies having to distort their group structures to offset any loss as it arises, and rollover relief to prevent a disincentive to replace business assets.

In addition, simpler taxes would be unlikely to remove the desire of taxpayers to undertake tax avoidance. They would probably require simpler antiavoidance laws, but these would still be required in such areas as diverting profits overseas to lower tax jurisdictions and disguising interest as a tax-free dividend from a U.K. company.

Martin (2005a) notes that his proposals for simplification can be achieved without altering tax rates. He states, “The question of whether simplifying tax and reducing tax rates are connected, or whether they are independent objectives, needs to be properly analyzed,” noting that simplification has its limits, and review of existing law is more likely to establish them rather than discarding all current law and starting again.

“Flat Tax”

The history of flat tax falls into two distinct phases. The first phase was the development of a theoretical tax system by American academics throughout the 1980s and 1990s, the most dominant model being the Hall Rabushka (HR) flat tax. The second phase was the actual introduction of tax systems known as “flat taxes” from the early 1990s to date, pioneered by a number of Eastern European countries and henceforth designated “EE flat tax.”

It is vital to bear in mind that the flat taxes of the second phase bear little relation to the HR flat tax or its associated theoretical models. It is obvious that certain commentators do not appreciate this fact, leading to a general lack of coherence in the flat tax debate which has been described by Keen et al. (2006) as “marked more by rhetoric and assertion than by analysis and evidence.” Much of the argument to date has focused on such issues as the reduction in marginal rates of tax paid by the highest earning individuals on the introduction of a flat tax system, and whether overall tax revenue would decrease. Other aspects of the “flatness” of flat tax, including its proposed simplifying features, have been subject to little analysis.

Definitions of "Flat Tax"

Generic definitions of flat tax may apply to both HR and EE flat tax systems. A short but useful description was provided by the U.K. Treasury in its 2005 report, which defined a flat tax as "a tax structure that has a single positive marginal tax rate."

In the U.S., the General Accounting Office (1998) prepared a report which noted that the term "flat tax" could refer to any system with a single tax rate using either a consumption or income base, but chose the HR flat tax to analyze. The Joint Committee on Taxation produced a report in 2005 discussing issues relating to flat tax proposals, which considered a flat tax to be "any tax system with only one marginal tax rate [above zero] and a broad base." Many flat tax systems, both theoretical and actual, substantially alter the existing tax base, a point deemed important enough to be included in this generic definition of a flat tax.

A final definition is provided by Weisbach (2000) who considered the design and implementation of the HR flat tax. He identified immediately the problem of defining the term "flat tax" and gave a generic definition of "any tax that has a proportional rather than progressive rate structure."

Hall-Rabushka (HR) Flat Tax

The first use of the term "flat tax" was coined in the work of two American academics, Robert Hall and Alvin Rabushka of the Hoover Institution, Stanford University. Their proposed flat tax system was published in the *Wall Street Journal* in 1981 and expanded in their book, *The Flat Tax* (1995). The HR flat tax system was put into a draft legislative form by Richard Armey and Richard Shelby and given political prominence by a number of American politicians, most notably the Republican Steve Forbes, who used its principles in his bid for nomination as his party's presidential candidate.

The HR flat tax is a theoretical model tax system designed to replace the American tax system. Its publication originally stimulated debate in the U.S. throughout the 1980s and 1990s and reached Europe during this second decade, especially following the novel tax reforms seen in Eastern European countries.

In practice, no country has adopted the HR flat tax in its pure form, and it remains a theoretical model only. None of the countries that have introduced tax reforms described by some as "flat taxes" has altered its tax base

from income to consumption, probably the single most significant difference between the HR flat tax and the current U.K. and U.S. tax systems. All countries which have introduced flat taxes already had a consumption tax in the form of a value added tax (VAT), a tax which does not exist in the U.S.

Definition

A succinct definition of the HR flat tax is provided by the Congressional Research Service of the Library of Congress (2005), which describes it as "a wage tax and a cash-flow tax on business (a wage tax is a tax only on salaries and wages; a cash-flow tax is generally a tax on gross receipts minus all outlays)… It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level." Both taxes are levied at the same, single, "flat" rate, with a tax-free personal allowance for individuals.

Businesses pay tax on the difference between their gross sales and the sum of wages, pension contributions, and purchases from other businesses, including the cost of materials, services, and capital purchases. Individuals pay tax on their wages (including benefits in kind) and pension disbursements, less personal exemptions.

Eastern European (EE) Flat Taxes

During the last 15 years, a number of Eastern European countries have reformed their tax systems by introducing regimes which have collectively become known as "flat taxes." Similar systems had already been introduced in certain countries, including Hong Kong (1947), Jersey (1940), and Guernsey (1960), but the more recent adopters may be grouped conveniently into two "waves." The first wave commenced with Estonia in 1994 and the second with Russia in 2001. Although flat taxes have been debated keenly in the U.K. and the rest of Western Europe, none of these countries has yet adopted similar systems, so that the results of the new tax systems have been analyzed with some interest.

The EE flat tax systems recently introduced vary widely in design. Their only common feature is that their tax on labor income may be described in symbolic form, as per Keen et al. (2006):

$$T_F(Y) = \max[t.(Y - A_F), 0]$$

where:

$T_F(Y)$ is the tax liability on income of Y,

t is the single marginal rate of tax (the "flat" rate), and

A_F is a tax-free allowance given to the taxpayer.

Keen's formula still meets the U.K. Treasury's generic definition of a flat tax.

The flat rate used to calculate both taxes may be the same, as under the HR flat tax, but, in practice, this is unusual among the EE flat taxes. Keen's analysis of EE flat taxes only considers tax systems that follow the above equation for PIT, incorporating as it does a personal allowance which is an important design component of these real-life flat taxes.

Potential Simplifications of a Flat Tax

Supporters of flat taxes, both HR and EE varieties, have long held that significant simplification of the current tax system would occur should their favored system be implemented. Indeed, even opponents have often implicitly accepted the claim, while sometimes questioning the extent of the impact of their introduction.

HR flat tax proponents such as Armey (1996) routinely claim that compliance costs would be cut were it introduced. The claim of its creators that individuals and companies would be able to file their tax returns on a postcard-sized form, and the hint that lengthy tax legislation can be swept away by a simple law, were important factors in its initial appeal. Superficially, the abolition of a number of exemptions and the reduction in the number of tax rates appear powerful simplifying features.

A typical view of flat tax supporters is that of Davidson, who agrees with Mitchell (1998) that "two of Mitchell's benefits are unambiguously correct: a flat tax is simple and honest." The McLeod Report (2001), a study of New Zealand's tax systems, concluded that a proportional income tax (or flat tax) would "be simple and resolve several complex taxation issues."

Limitations of Flat Tax Simplification

Martin (2005) considered the effect of a flat tax in the context of EE flat taxes on U.K. tax legislation. He agreed that such a flat tax would remove many of the reliefs that cause legislative complexity. However, he points out that abolishing all of the reliefs noted by Teather (2005) would be likely to repeal only 1 percent or 2 percent of current direct tax law, doing little to remove complexity generated by length.

Martin (2005) concludes that "simplification of the tax system is ultimately a matter of political will and conviction. An attractive panacea—such as the flat tax—will not in itself solve the problem of complexity." He notes that supporters of flat taxes and their potential for simplifying the U.K. tax system should beware of the danger identified by Mencken that "for every complex problem, there is a solution that is simple, neat, and wrong."

Analysis of the EE Flat Taxes

Keen et al. (2006) undertook a detailed analysis of the EE flat tax systems. There is already a large amount of academic literature on behavioral and overall tax revenue effects of changing tax rates, issues which, as already noted, have been prominent in the flat tax debate. However, there has been little analysis of the effect of "flatness" per se, although, as Keen et al. (2006) point out, "it is difficult (perhaps impossible) to disentangle these empirically from those of the accompanying tax increases or reductions that movement to a flat tax implies."

Keen et al. (2006) note a few obvious simplifications arising from the flatness of tax rates, including reducing incentives to reallocate income, making withholding simpler, and simplifying income averaging. However, the tax-free allowance means that none of these problems disappears since there are two marginal rates (the flat rate and zero). PAYE would still be problematic for individuals with more than one job to ensure that the tax-free allowance is only claimed once. Income averaging is a negligible part of the overall complexity burden.

More importantly, it is generally agreed that the rate structure is not the main source of complexity in a tax system. Factors to which complexity can largely be attributed include difficulties in defining the tax base due to legislative exemptions and special treatments which may be disputed at length between taxpayer and tax authority.

Overall, Keen et al. (2006) conclude that there is little tangible evidence for flat tax simplification solely due to their property of "flatness."

This was not a surprising observation as simply changing a tax rate is predicted to have little effect on the much deeper, inherent complexity seen in real life tax systems. The summary of the U.K. Treasury agrees with this viewpoint that "having a progressive rate schedule with a reasonably low number of income brackets is probably not much more complex than having a single rate from an administrative point of view." Some indirect survey evidence from Ivanova et al. (2005) in Russia did not suggest that individual taxpayers thought the tax system much simpler post reform.

Fundamental Problems of Tax Simplification

Gale's (2001) conclusion effectively sums up the difficulties associated with tax simplification, both generically and linked to the "flat tax":

> "As a purely technical matter, tax complexity and tax evasion can be reduced, and tax administration can be made more just and efficient. As a political and policy matter, however, making these improvements has proven quite difficult. Efforts to simplify the tax system typically run up against conflict with other tax policy goals, political factors, taxpayers' efforts to avoid and evade taxes, and revenue requirements. Each of these factors tends to shape the base, credits, deductions, rate structure, and administrative aspects of the tax system in ways that raise complexity. Efforts to reduce evasion sometimes run into similar problems.
>
> To the extent that simplicity is a goal of tax reform, many improvements could be made within the existing system. Pure versions of both the national retail sales tax and the flat tax could be vastly simpler than even an improved income tax. But realistic versions of the flat tax and especially the sales tax would require tax rates much higher than advertised by their proponents. These higher rates complicate tax compliance and enforcement. The sales tax would face potentially serious problems with enforceability and political pressure for exemptions. The flat tax would face the same political pressures, and, while enforceability is not a major issue, the tax would likely become significantly more complex than currently proposed."

CGT Reform in the U.K.

On October 9, 2007, the U.K. Chancellor, Alistair Darling, announced an unexpected reform to the U.K. CGT system, effectively proposing a flat tax rate of 18 percent on capital gains for individuals and unincorporated businesses. The proposal was without doubt a simplifying one as it removed the need for complex calculations of taper relief, which reduced a capital gain depending on the number of years of ownership of the asset, as well as whether the asset had been used for "business" purposes. The result was a range of effective CGT rates from 5 percent to 40 percent.

Taper relief was originally introduced by the incoming Labor government to encourage entrepreneurship and create jobs. Endacott (2008) notes that the government was influenced by U.S. thinking, including a 1997 study of the venture capital industry by Gompers and Lerner which highlighted a negative correlation between a CGT rate and the magnitude of venture capital investment. However, the report noted that the tax rate was only one of several factors to consider and described it as a "blunt instrument."

However, the legislative provisions for taper relief were lengthy and complex, and, when they were described by financial journalist Martin Wolf as "a mess," few would have disagreed. The concept of a "business asset" was chosen to promote active risk-taking rather than passive investment, but its definition was complex and often apparently arbitrary. The far more generous relief that such assets attracted compared to "non-business assets" was in some cases very hard to justify. In addition, the increasing relief depending on the length of time the asset was held was criticized by some as introducing arbitrary time limits to distort investment decisions.

"Flat Tax" Connection

It was somewhat ironic that the U.K. government introduced the proposed reforms using some of the rhetoric of supporters of "flat tax." While the U.S. has a long and distinguished history of flat tax debate, the concept is much newer in the U.K. and has met with little favor to date in government circles. HM Treasury produced a critical report in 2005, mainly on equity grounds, and the debate largely subsided.

Admittedly, the proposed U.K. CGT reforms bore little resemblance to the original flat tax model of Hall and Rabushka and its subsequent

development in the U.S. Under their model, capital gains are not taxed at all. However, useful comparisons can still be made as to how the flatness of a tax rate impacts on the simplicity of the underlying tax system.

In addition, it should be noted that the 2005 Treasury report highlighted the fact that no flat tax system had been introduced in an economy similar to the U.K., so that any conclusions about its effectiveness would be largely speculative. While CGT is a minor tax in terms of the revenue it raises, such a comment is now a less valid one.

Taxpayer Response

Given the purported desire for tax simplification in the U.K., it might have been expected that this proposal would have met with a broadly favorable response from taxpayers and their advisers. However, the exact opposite occurred. The reforms were bitterly denounced by representatives of small business, principally on the basis that, under the old system, many of their constituents would have expected to pay a rate of no more than 10 percent on disposal of shares in their companies. Emotive phrases such as "80-percent tax rise" succeeded in attracting much media attention. Simplification proved to be a principle readily sacrificed to avoid even a modest tax increase, with the General Secretary of the Trades Union Congress describing the Chancellor as having "called the bluff of those business leaders who have long called for tax simplicity."

Other arguments from the reform's opponents included the need for stability in a tax system, the damage to the country's entrepreneurial culture with the prospect of wealth generators choosing to set up business in lower tax jurisdictions, and the prospect of a "finance gap," deterring external investors from financially supporting small businesses.

The behavior of tax practitioners in response to the reform was predictable. After initial complaints that the reforms had not undergone a proper consultation process, a number of schemes were devised for clients based on draft contracts of sale dated before April 6, 2008 (the date the reforms took effect) to take advantage of the lower tax rates under the previous regime. This pragmatic approach was demonstrated in the actions of the prominent tax consultant Kevin Slevin who was quick to denounce the reform as "the Darling Raid on small businesses." Yet, by July 17, 2008, he had written the first book to market on the subject of entrepreneurs' relief, available for sale to fellow practitioners.

Government Reaction

In the event, the government gave in to demands and introduced further legislation known as entrepreneur's relief, based on repealed legislation known as "retirement relief." This effectively gave taxpayers the ability to continue to pay only 10 percent on the first £1 million of capital gains, with any excess taxed at 18 percent.

From a simplification point of view, this response was disastrous, leading to greater volume of tax law and maintaining the complexity of calculating a capital gain. As with taper relief, with which it shares a number of similarities while not providing as generous a relief, entrepreneurs' relief creates distortions and influences investment behavior. Endacott (2008) points out that the relief introduces substantial complexity for the small amount of relief it provides. The Chartered Institute of Taxation, the representative body for chartered tax advisers, noted that retirement relief provisions, which formed the basis for entrepreneurs' relief, contained elements that were "notoriously difficult to apply and, in practice, gave rise to a number of problems for both taxpayers and HMRC."

Conclusions

In summary, the recent experiences of the CGT reforms provide evidence of the difficulty any government would face in trying to introduce significant simplification to the U.K. tax system, be it by flat tax or any other means, given the response to proposals to modify one minor tax. They also show that, even if a simple tax system could be introduced, the pressures for special interest groups may be too much for government to ignore, leading to further legislation and increased complexity.

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