Think Ahead ACCA

Foundations for a sound tax system: simplicity, certainty and stability

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of 92 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

Simplicity, certainty and stability: in ACCA's view these are the three cornerstones of a good tax system.

Policy makers should consider them any time they plan to change the tax system. They are also the benchmarks by which taxpayers can assess the effectiveness of government in maintaining and improving tax systems.

This paper references three earlier ACCA papers.

- **Stability in Tax**
  http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2015/may/stability-in-tax.html
- **Certainty in Tax**
  http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2014/november/certainty-in-tax.html
- **Simplicity in Tax**
  http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2013/november/simplicity-in-the-tax-system.html

1. Introduction

Tax should exist to create benefits for society, not be a burden upon it.

Tax systems are fundamental to society. They are the conduit through which the state gathers the resources it needs to support public spending, and are often the direct mechanism of implementing policy. Every citizen is affected by the operation of tax systems, and the efficiency and effectiveness of the system and its administration will have effects far beyond the direct impact of tax collection.

Tax systems have grown ever more complex, reflecting the societies and economies in which they operate. As the world changes around them, tax systems must change to keep up. The arrival of the container, the executive jet and the internet have changed the face of world trade and domestic economies beyond all recognition. The enhanced mobility of goods, people and capital has transformed societies but the importance of tax in maintaining those societies is undiminished.

The three functions of a tax system (revenue raising, redistribution and regulation of economic behaviour) will be achieved in different ways at different times. As policy makers react to change, and seek to influence it themselves, they will be faced with choices over what to tax, and how to do so.

ACCA has identified three fundamental considerations which every system should strive for, and by which citizens can measure the success of governments and tax administrations in developing laws and processes, and the resources to administer them, for the greatest benefit of society. Regardless of the policies adopted by government, the role of the tax system in funding or implementing them should be designed to best reflect the optimal balance between simplicity, certainty and stability.

2. Simplicity

Complexity costs: it distorts behaviour and wastes resources.

Understanding and complying with tax legislation should be as simple and straightforward as possible.[1] If taxpayers and their advisers face too complex a tax system and are unclear what is expected of them, this creates the potential for mistakes and deliberate rule-breaking. Complexity in the tax system distorts the economy, diverting productive energies into non-productive administration.

WHY IS TAX SO COMPLICATED?

Tax systems can perform multiple roles: raising revenue, redistributing wealth and regulating behaviour (eg through excise duty on alcohol or 'green taxes'). These roles may be achieved in several ways: by taxing spending (eg through value added tax (VAT) or goods and services tax (GST)), receipts (personal or corporate income) or capital. Single taxes may be intended to support more than one aim.

Implementing tax also has complexity: even when based on legislation, supplementary guidance or case law may be required. Tax authorities, taxpayers and advisers will interpret the rules – not necessarily in the same ways.

In practice, much of the complexity experienced by taxpayers and advisers stems from policy implementation: confusing paperwork, ambiguous or inconsistent legislation and dysfunctional bureaucratic processes. Additional complexities are created when governments are tempted to grant exemptions for certain taxpayers or draft anti-avoidance legislation.[2]

Anti-avoidance legislation requires taxpayers to keep up-to-date with targeted rules, or to 'second guess' the intentions of the legislature when trying to understand the tax impact of transactions.

Taxes must also be calculated and assessed, which can happen in a variety of ways (eg by paper forms or online) and at different periods (eg annually, quarterly or on an ad-hoc basis). Collection methods also differ. For example, with transactional taxes, it often isn't the taxpayer who remits the tax to the authorities (as with VAT and income tax on employment earnings).

Economic growth appears to be more strongly linked with reducing the administrative burden on business than with cutting tax rates.

Taxpayers face even more complexity when operating across multiple jurisdictions, which may apply rules in different ways and have different tax rates.

WHAT ARE THE ADVANTAGES OF SIMPLIFICATION?

ACCA believes that a commitment to achieving simplicity in the tax system will produce the following benefits:

- reduced cost of administration;
- greater accountability through clarity and transparency; and
- improved stability, because the potential for unintended consequences and need for counteracting measures are reduced.

It's also notable that reducing the administrative burden on business appears to be more strongly linked with economic growth than cutting tax rates.

1 See *Simplicity in Tax* (ACCA 2013).

2 See *Global policy on Taxation of Companies: Principles and Practices* (ACCA 2013). for further discussion of the complexity of tax avoidance.

HOW CAN GREATER SIMPLICITY BE ACHIEVED?

Technology can play a part in reducing the administrative burden on business, by enabling online filing, reducing the need for repeated taxpayer input, and even removing the human element from data input altogether. Many jurisdictions now base filings on accounts prepared in XBRL (Extensible Business Reporting Language) which is easily readable by other software.

Simplicity can be encouraged by restricting adjustments to standards-compliant accounting when preparing tax computations. Where adjustments are necessary, these should be specified as clearly as possible.

Drafting simpler tax legislation doesn't necessarily mean shorter legislation. It also needs to be usable and understandable. This is particularly important in countries where taxpayers self-assess their liability and will be the primary users of the legislation.

The most fundamental driver of simplicity (or complexity) in a tax system is the intended function of tax. A system designed purely to raise revenue is more likely to be simple, as the only design constraints are neutrality and efficiency. Mechanisms that introduce choices for taxpayers, and taxes designed to influence behaviour, are more likely to increase complexity.

Policy makers should try not to make any one tax do too many things, and should not use too many different taxes to try to achieve the same aim – for example, corporate income taxes get used to raise revenue, to redistribute corporate profits from the wealthy (the business owners who would otherwise ultimately benefit from the surplus), and to regulate business activity, through eg enhanced deductions for installing 'environmentally friendly' plant and machinery. Introducing the various targeted aims inevitably results in complication. And then there is the overlap; direct levies on carbon use or energy consumption have similar aims to the 'green' elements of corporation tax. Operating two systems with the same aim needs to be carefully considered if governments are to avoid waste and complexity in their tax collection regimes.

> The number of tax rules, and their ability to interact (or even conflict) with each other, should be kept to a minimum.

Note that the concept of fairness doesn't necessarily align with simplicity. The simpler and less granular a tax system, the less finely it will be able to differentiate between the circumstances of different taxpayers. A flat tax is theoretically the ultimate in simplicity, but has no 'progressive' element.

In general, to encourage simplicity, the number of tax rules, and their ability to interact (or conflict) with each other, should be kept to a minimum.

> Tax law and tax administration should be simple. Society as a whole pays the price for complexity.

3. Certainty

Certainty in a tax system is important. Without it neither governments nor taxpayers can effectively budget or plan for their future actions.

Certainty in a tax system is important because without it neither governments nor taxpayers can effectively budget or plan for their future actions. Yet every system incorporates uncertainty to some degree, and it may even be encouraged.

BENEFITS OF CERTAINTY

Policy makers need to be able to base future spending plans on a realistic assessment of expected income. Certainty also benefits taxpayers. It helps them choose between alternative transactions, and to decide whether to proceed with an individual transaction.

Where there is uncertainty over the tax position of a transaction, prudent taxpayers may reserve funds against the potential liability, restricting additional investment and so creating an opportunity cost. Where uncertainty leads to disputes between taxpayer and tax authority, the direct and indirect costs can be considerable.

HOW UNCERTAINTY CAN ARISE

Uncertainty can develop at any stage of the tax-assessment cycle – when identifying tax transactions, valuing them and applying tax law to them. The threat of retrospective legislation is particularly devastating, generally reserved by governments to counter clear abuse.

Corporation taxes are typically based on an adjusted value of published accounting profit, but that may rely on subjective valuations. In addition, the same concept – such as depreciation (gradual writing down of the cost of an asset to reflect its use) – may be applied differently under accounting and tax rules. The same transaction may also have a different tax treatment depending on who makes it.

A purposive interpretation of legislation – where tax law is to be applied in line with its intended purpose – creates uncertainty. This is particularly demonstrated by the general anti-avoidance, or anti-abuse, rule – a principles-based approach designed to protect society from unacceptable tax avoidance, but an inevitable cause of uncertainty.

The involvement of the judiciary in interpreting tax law also has an impact. Judicial precedent can change overnight, while the appeals system and potential for multiple opinions can cause additional uncertainty for taxpayers.

The treaty-based system of international tax (which follows legal form to allocate tax characteristics) has created some uncertainty for international businesses, which some managers or owners have exploited. However, the alternative (a unitary tax model) would introduce different uncertainties. Instead of taxing each company's locally accounted profits, the system would tax a proportion of the whole (global) profits of the business on the basis of the proportion of its sales, assets and labour recorded in the jurisdiction.[3]

Resolving uncertainty is a poor second best to avoiding it in the first place

ABUSE OF UNCERTAINTY

Abuse of uncertainty poses risks to the exchequer. Taxpayers may seek to use it to their advantage when interpreting tax law, while tax officials may also seek an undue advantage, for themselves or the state. Corrupt tax officials could, for example, attempt to impose excessive tax demands in the hope of receiving a bribe.

Extending discretion to tax authorities to 'do a deal' poses a further risk to the tax system in the form of undisclosed state aid. Such deals will typically be limited to the largest multinationals or wealthiest individuals, and could give them significant advantages through lower effective tax rates.

3 See *Certainty in Tax* (ACCA 2014) for more explanation of the issues.

DELIBERATE UNCERTAINTY

In some cases taxpayers seek to introduce uncertainty deliberately, eg through an artificial avoidance scheme based on a tenuous interpretation of the law or facts. In practice, uncertainty usually results from the tax and accounting system failing to capture the reality of a transaction clearly.

Taxpayers cannot be expected to avoid all such areas of uncertainty. Managers of a business have duties to protect the interests of the owners and other direct stakeholders in the business, which may exceed their legal duties to wider society.

Any objectively certain tax regime would have to consider every possible transaction and interaction, making it far too complex. Once governments accept some circumstance-based uncertainty is unavoidable, they may be tempted to extend the boundaries of uncertainty deliberately. They may expect prudent taxpayers to wish to minimise tax risk and so pay more tax in order to be sure of escaping challenge. Such actions by government are just as open to criticism as actions of taxpayers seeking to exploit uncertainty through aggressive avoidance schemes.

WHAT CAN POLICY MAKERS DO?

Policy makers need to understand the tension that exists between simplicity and certainty. The interests of larger businesses are better served by certainty, while individual taxpayers will require simplicity. The relative importance of simplicity and certainty to smaller businesses will depend on their aims, activities and resources. Designers of tax systems need to reach a compromise between conflicting needs.

Limiting the damage done by uncertainty should be a primary objective of tax system designers

Where governments use administrative or judicial discretion in the tax system, clear guidance will be needed. For large businesses, transparent clearance mechanisms allowing taxpayers to discuss proposed transactions in advance could help to address any uncertainties arising when interpreting legislation.

Agreeing consistent treatments for cross-border transactions is key to confident international trade

4. Stability

If uncertainty about tax is going to stand in the way of projects that would otherwise benefit society then it has failed in its objective.

Stability is closely related to certainty. 'Certainty' is about knowing what the answer to a given question ought to be; stability is about whether the current answer will still be correct in one, two or ten years' time. Stability extends to the rates at which calculated values are taxed and the administrative practices surrounding that process in a way that certainty does not.

WHY STABILITY MATTERS

For taxpayers, stability is essential for effective planning and efficient ongoing compliance. Individuals can budget household income more accurately, while businesses are encouraged to make investment decisions. Businesses would typically prefer to operate in a slightly more imperfect system than in one where incremental improvements are made every year.

If uncertainty about tax is going to stand in the way of projects that would otherwise benefit society then it has failed in its objective.

Stability is particularly important for enabling investment in large infrastructure and development projects, as businesses need reassurance that the tax rules won't change part way through. Concerns about the stability of a tax system will be reflected in the overall risk weighting give to new investments.

TAX RATE STABILITY

Across most OECD nations, general consumption taxes (eg VAT) and personal income taxes generate most revenue, followed by corporate income taxes. The rates of such taxes need to be moved only minimally to generate a significant revenue impact. The number of changes can be kept to a minimum, and the burden spread across a comparatively wide base. Targeting a smaller population is likely to be more disruptive and divisive.

Stability is fundamental to effective planning and efficient compliance.

At a macro level, sudden shifts in tax rates can be bad for business and consumer confidence. When step changes are prompted by major events (eg war), the tax burden rarely falls back to its original level. Governments generally find new ways to spend the money.

TAX BASE STABILITY

Changing tax rules that affect the tax base has an economic and compliance cost. The more regular the change, the greater the cost. For smaller businesses in particular, large infrequent changes are generally preferable to successive small ones.

The need for any change should always be considered carefully, as should the mechanics of implementing the change and its interaction with the rest of the tax system. Impact assessments are useful tools for legislators to model the outcomes of changes, but Policy makers must take account of real world conditions. The UK system of tax credits, for example, has merit as a model, but operational weaknesses.[4]

TAX ADMINISTRATION STABILITY

The administration of tax systems changes as technologies change, bringing scope for greater efficiency and effectiveness. Nevertheless, system changes must always be made with care, particularly in relation to withholding mechanisms for employment taxes or consumption tax returns and processes. Successful change requires clear communication from the authorities and adequate time (for systems development and educating taxpayers).

Investment in the training and retention of staff at every level should be a priority.

4 See *Stability in Tax* (ACCA 2015) for more detail.

Efforts should also be made to ensure that tax authorities are staffed with well trained, motivated individuals. This encourages higher quality tax administration, not least through the maintenance of institutional memory which can reduce the likelihood of repeated mistakes.

THE WAY FORWARD

Change for the sake of it would be a bad thing in a tax system. Politicians and tax Policy makers should always think carefully about whether the tax system is the best way to achieve a desired change in society.

Some political systems support a consensus model of decision making, which can enable a more stable and predictable tax system. Though politicians may lose some of their discretion to shape tax policy, society may benefit. A measured and well signposted programme of predictable change represents the optimal, pragmatic compromise.

Tax systems could benefit from some kind of independent oversight of tax policy and the effectiveness and efficiency of the system. This would reassure taxpayers and investors that non-partisan aspects of the tax system are not being compromised for short-term political ends.

Mechanisms for change are an essential feature of any healthy system.

Greater consistency in cross border and internationally applicable taxes would also benefit taxpayers and authorities, reducing scope for disputes and arbitrage. Greater stability should be achieved as domestic authorities converge on common models.

5. Conclusion

Tax should exist to create benefits for society, not be a burden upon it.

Today's world changes faster than most legislatures can update their tax law. Policy makers may need to accept short-term imperfections, while taking a measured approach to implementing genuine structural improvements which meet the principles of simplicity and certainty in a transparent and accountable way.

A good tax system, like a simple stool, depends on three things for its strength and solidity. Simplicity, Certainty and Stability. And like a tripod, if any one of the legs is deficient, the whole thing is likely to fall over. The principles to some extent overlap and are interdependent. If the system is not simple, its impact is less likely to be certain. Breaking down the analysis of the system methodically is far more likely to create a consistent and coherent outcome that goes at least some way towards achieving the desired aims without any undesirable side-effects.

The balance of the factors will be different in different cases, but perhaps the key is simplicity; once that is in place, certainty and stability will flow as a natural consequence. Policy makers should try not to make any one tax do too many things, and should not use too many different taxes to try to achieve the same aim. Operating two systems with the same aim needs to be carefully considered if governments are to avoid waste and complexity in their tax collection regimes.

The importance of the tax system to individuals and society is so great that it should not be treated as a short-term political football, but seen instead as the bedrock of constitutional funding, and recognised as an integral and pervasive element of every business and individual's environment. A good tax system will benefit both a government and its populace; a poor one will discomfit individuals and discourage business, with impacts far beyond the tax system itself.

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