

Chapter 1

The Tax System

In this chapter we will be looking at the taxation system in the UK. We will look at the purpose of taxation and how it is administered. We will look at some of the legislation covering taxation and how the government have introduced laws to prevent tax evasion and abusive avoidance schemes. Finally, we will look at the responsibilities and ethics behind giving tax advice.

Taxation is one of the most emotive areas of accountancy. Few people enjoy paying taxes and many feel that it is unfair. And yet without taxation we would have few of the advantages it brings to current-day society.

The purpose of taxation

A government will collect taxes from its citizens to pay for what it feels is for the good of the population. In the UK, taxation is used to raise money for public services, such as the National Health Service, education and welfare services, as well as investment in public services such as roads, rail and housing. Taxation also funds the armed forces.

The government also uses taxation to control the economy. For example, taxes can be cut in a recession in order to stimulate spending. People will have more disposable income. Conversely, taxes can be raised to reduce inflation where people will have less disposable income.

Types of behaviour are controlled using taxation. For example, taxes are increased on smoking products to encourage us to smoke less, whereas taxes on green products are reduced to encourage us to use these in preference to other more environmentally harmful products.

The principles of taxation

Adam Smith is considered the founding father of economics. (He is depicted on the reverse side of the paper version of the £20 note). In his book, *The Wealth of Nations*, written in 1776, he argued that taxation should follow four principles: fairness, certainty, convenience and efficiency.



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Taxation should be perceived to be fair or **equitable**. This is understood to mean that taxation should be based on the taxpayer's ability to pay. However, it also means that taxation should be **neutral**. The Government should not favour one type of business over another. All individuals or industries should pay the same rate of tax given the same situation.

Certainty means that taxpayers should be clearly informed about how taxes are levied. Rules should be easy to understand and there should be no room for discretion by tax officers. It also implies that the rules should not be changed retrospectively.

Convenience relates to the ease of paying and collecting taxes. For example, employees have their tax deducted before they receive payment (under Pay As You Earn (PAYE)). Most employees don't have to do any calculations or report anything to do with tax.

Efficiency means that the cost of collecting taxes should be kept to a minimum.

While these principles form a sound basis for taxation today, it is not always followed. Some taxes are not transparent. For example, fuel excise is a tax on the fuel we put in our cars, but there is no indication on our bills how much has been paid. Some taxpayers are burdened with the task of filing annual tax returns online which is not as convenient as the PAYE system. Sometimes it is not cost efficient to prosecute those who evade or avoid taxes as has recently emerged in the news about some large international companies who pay far less in UK tax than was intended by government.

The UK tax system

In the UK, while the government decides what taxes are to be levied and at what rate, the collection of these taxes is administered by **His Majesty's Revenue and Customs (HMRC)**.



The government work on a tax year for sole traders and partnerships which runs from 6th April to the following 5th April This is known as the **tax year**, the **fiscal year**, or the **year of assessment**. For limited companies it is slightly different. The **financial year** for limited companies runs from 1st April to 31st March.

There are many different types of tax all of which are calculated from the **tax base** (which is the amount to which tax can apply), and then multiplied by a **tax rate** (which is a percentage of the tax base). From time to time, governments change the tax base and the tax rate.

In this book, we will be looking at four different types of tax; Income Tax, National insurance, Capital Gains Tax and Corporation Tax.

For income tax, the tax base is the income received by the individual. There is usually an annual allowance (called the **personal allowance**) where some income up to a certain level is not taxed at all. Anything earned above this level will be taxed at certain rates, which will vary

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according to the level of income. The income is calculated on an annual basis, Income tax is a **progressive** tax, meaning that the rate will increase as the tax base increases.

For National Insurance the tax base will be the individual's income, and there is also an allowance where some income is not subject to National Insurance Contributions (NICs). The tax rate again varies according to the level of income. National Insurance is a **regressive** tax, meaning that the tax rate will decrease as the tax base increases.

(For comparison VAT is essentially a **proportional** tax, meaning that everyone pays the same rate regardless of their income. However, VAT was covered at the Level 3 Diploma of your studies and won't be assessed again in this unit.)

For Capital Gains Tax the tax base is the amount of profit made on many capital items such as antiques and investment properties. The tax rate will vary according to the level of income and the size of the gain. It is a progressive tax.

Limited companies pay Corporation Tax on all their profits and gains. While there are slightly different rules for each type of profit or gain, they are eventually all added together and charged Corporation Tax on the total tax rate.

Legislation

The laws on taxation in the UK are made by the British Government. There are two parts to these laws.

Acts of Parliament are created by Members of Parliament debating in Parliament. There are a number of Acts that form the main rules for each of the UK taxes. They are updated each year by the annual **Finance Act**. The Finance Act is given a year and is the start of the tax year. So, the rules that relate to the 2023 to 2024 fiscal year is the Finance Act 2023.



Acts of Parliament usually give the main rules, but don't include the detail of how the rules will operate. Therefore, civil servants, acting on behalf of the Chancellor of the Exchequer create **Statutory Instruments (SI)** to provide the detail of what is set out in the Act. An SI will be laid before parliament and becomes law if there are no objections to it.

A taxpayer and HMRC may disagree over the interpretation of the legislation. Such disagreements may be heard by a **tax tribunal**. The tax tribunal will decide on the correct interpretation, after which all future taxpayers and HMRC Officers must follow the decision. The interpretation becomes law and it is known as **case law**.

HMRC may publish a **statement of practice**. This is not a law in itself but simply a statement to explain how HMRC interprets the legislation and applies the law in practice. A statement

of practice does not affect the rights of the taxpayer to challenge the interpretation in a tax tribunal.

HMRC may also publish **extra-statutory concessions**. This is where HMRC allows certain tax concessions to taxpayers. This may give the taxpayer a reduction in tax liability to which they are not entitled under the strict letter of the law.

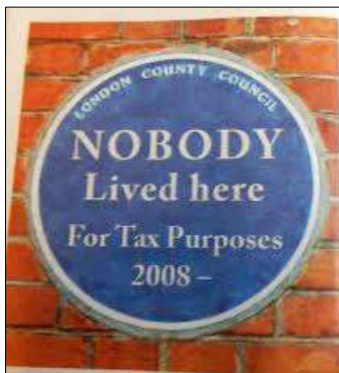
HMRC publishes a range of guides and help sheets to help taxpayers complete the necessary forms and to calculate their tax liability. They can be downloaded from www.gov.uk. **Readers are advised to use this site for extra information regarding the topics covered in this book.**

Tax Evasion, Tax Avoidance and Tax Planning

It is the responsibility of the taxpayer to tell HMRC about any source of income they are not aware of. Employees paying tax weekly or monthly through Pay As You Earn (PAYE) do not need to inform HMRC. However, the self-employed, partners in a partnership and companies need to inform HMRC about their trading income and chargeable gains (the profit made on selling capital assets). There are fines and penalties if you don't.

No one likes paying tax so it is inevitable that taxpayers will seek ways and means of paying less.

Tax evasion is where there is a deliberate attempt not to pay the tax which is due. This can involve deliberately concealing income or reporting less income than was actually received. This practice is illegal and can have serious consequences, from financial penalties to criminal convictions or even imprisonment.



HMRC defines **tax avoidance** as 'bending the rules of the tax system to gain a tax advantage that Parliament never intended'. Tax avoidance isn't illegal, but it uses contrived or artificial transactions that serve no purpose other than to produce a tax advantage for the taxpayer. It involves operating within the letter of the law but not the spirit of the law.

Until 2013 the courts appear to have sided with the taxpayer, saying that they had every right to reduce their tax burden by whatever legal means they could. The government didn't see it this way. They saw it as everyone's duty to pay their fair share of tax. It wasn't right that the more affluent taxpayer could employ clever accountants to find contrived ways to reduce their tax bill. Therefore, in 2013 legislation was introduced to outlaw some of the more abusive schemes. This legislation is known as the '**General Anti-Abuse Rule**' (GAAR).

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The legislation is not aimed at legitimate reliefs or tax choices. For example, investment in ISAs (see later in this book) is a way of reducing the tax burden of individuals which the government foresaw and actively encourages. However, the legislation does target abusive schemes where taxpayers set out to exploit some loophole in the tax laws, for example, by entering into contrived arrangements to obtain a relief but suffering no equivalent economic risk.

The GAAR only comes into operation when the course of action taken by the taxpayer aims to achieve a favourable tax result that **Parliament did not anticipate** when it introduced the tax rules and where that course of action **cannot reasonably be regarded as reasonable**.

Tax planning involves looking at an individual's income and using the rules in the most tax efficient manner. For example, paying into a pension scheme or giving money to charity are both legitimate ways of reducing the tax liability in ways the government anticipated and which are reasonable steps to take.

Professional Conduct in Relation to Taxation

A business may appoint a tax adviser to deal with their tax affairs. If the individual wishes to do this, they must inform HMRC and all correspondence (except bills or refunds) will be sent to that adviser (called the agent). The adviser must meet the HMRC standards of conduct and the AAT (along with other professional bodies) provide these standards in a document called 'Professional Conduct in Relation to Taxation' (PCRT). Readers are advised to read this document at <https://www.aat.org.uk/prod/s3fs-public/assets/AAT-professional-conduct-taxation-guidance.pdf>.

The document starts with the fundamental principles which apply equally to taxation as to any other area of accounting.



Ethical behaviour in the tax profession is critical. The work carried out by a member needs to be trusted by society at large as well as by clients and other stakeholders. What a member does reflects not just on themselves but on the profession as a whole.

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A member must comply with the following fundamental principles.

- Integrity

This is about being honest, truthful, straightforward and having strong moral principles.

- Objectivity

This is about not being influenced by personal feelings or opinions in considering or representing the facts. It is also about representing the facts as they are without the undue influence of others.

- Professional Competence and Due Care

This is about maintaining professional knowledge and skill and keeping up with new developments, legislation and techniques to ensure that the client or employer receives the best possible service. It is also about not acting recklessly and without due consideration of the facts.

- Confidentiality

This is about keeping information acquired as a result of business activities, secret. Such information should not be used for personal gain, or disclosed to anyone else without explicit permission to disclose it, or where there is a legal requirement to disclose it.

- Professional Behaviour

This is about acting in a professional way (both in the workplace and outside), being a law-abiding citizen, and not bringing the accountancy profession into disrepute.

Integrity

Integrity is basing one's actions on a framework of principles. It consists of obeying the rules of your professional work and doing the right thing. This isn't always as easy as it may seem. There may be pressures to breach your integrity. Doing the wrong thing might be brought about by external pressures. For example, your boss may ask you to falsify some figures. You know you may lose your job if you don't agree. But a person with integrity will not agree to do wrong. They will refuse to falsify facts no matter what the consequences.



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It may seem that power, fortune and success can be gained instantly if corners are cut and the constraints of moral principles are forgotten, but to build a reputation of integrity takes years, and you can lose it in a second.

We live in a world where we believe the end justifies the means. It may be tempting to overstate profits so that investors will put their money into the business. We may think there is nothing wrong with calling in 'sick' when in actual fact all we want to do is go Christmas shopping. How tempting is it to add a few miles onto the business travelling so we can get a few extra expenses out of the business? In every case, the person committing the act of dishonesty will convince themselves that they had a perfectly valid reason for their lack of integrity. However, this temporary monetary profit comes at a great price. Any trust can be lost forever.

The value of integrity is far beyond anything that can be measured. For people in business, it means that investors will trust them when investing their capital, and customers will come again and again to buy their goods with confidence. For employees, it means that the manager or boss will be willing to trust them with additional responsibilities. For the accountant, it will mean that the client can trust that the advice they are given will be fair, straightforward and honest.

Integrity applies equally to large and small matters. It applies to the recording of financial statements, where figures must not be misleading or inaccurate, and it applies to the expense claims for tea and coffee for the staff where the amounts must be accurate and genuine.

Objectivity

Objectivity is basing an opinion on the facts only, without personal opinions, stereotypes or based on the opinions of others. For example, if you describe an object objectively you can



state its colour, size and weight, but as soon as you say the object is ugly you are no longer objective. Whether it is ugly is based on personal opinion.

The principle behind objectivity is that if two separate accountants were asked to give advice on a particular topic, they would both come up with the same answer. If your managing director believes a particular asset is worth £50,000 but a professional valuation gives the price as £40,000, the asset should be recorded at £40,000. The £40,000 is objective because it is supported by a professional appraisal and is not subject to the managing director's personal opinion.

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There are two basic ways objectivity can be threatened

1. Conflict of interest

A conflict of interest is any situation that might cause an impartial observer to reasonably question whether your actions are influenced by considerations of private interests. 'Private interests' can include financial interests, interests related to your personal relationships, or interests related to other outside activities. For example, you may suggest that a contract is given to a company in which you have a substantial shareholding. Because you have a personal financial interest in the result, your professional judgement may be (or be seen to be) influenced by the situation rather than based solely on the facts.

Conflicts of interest can influence a decision either deliberately or accidentally. You may be faced with a situation where a close friend or family member is interviewed for a new job where you are involved in the hiring. Your objective opinion may be influenced.



You may be involved with another organisation which offers the same or similar services. If you are an employee of one accounting business and offer a similar service as a sole trader to similar clients you may be influenced in your judgement.

A conflict of interest exists whether or not the individual is actually influenced by the circumstances. It exists where the circumstances are reasonably believed to create a risk that decisions will be influenced.

Soliciting or accepting excessive gifts or hospitality is a common way in which a conflict of interest can arise. Accepting an occasional gift is acceptable where the gift is unsolicited, modest in value and provided openly. What is modest in value is not specified, but a bottle of wine at Christmas is acceptable but an all-expenses paid holiday to Bermuda is not. If you accept an expensive gift it may cloud your judgment and influence your advice or decision.

There are two ways to overcome a conflict of interest. You should either refuse the engagement, or you should declare the interest to the organisation or client when the decision is made.

2. Undue influence

This is where professional judgement will be affected due to one person's position of power over another person. For example, you may be told to report something that isn't true otherwise you will be overlooked for promotion. You should not be influenced in this way. If possible you should report this to a senior person in the company. If this has no effect, you should accept you will be overlooked and seek alternative employment. The business is acting unethically if not illegally and they are most likely to be found out at some time. You don't

want to be implicit in the unethical activity. This can have an even greater detrimental effect on your future career than not getting the promotion.

Professional Competence and Due Care

Professional competence is about maintaining professional skills and knowledge at a level to ensure that employers and clients receive a competent service. Continuing Professional



Development (CPD) is the means by which people maintain their knowledge and skills.

Due care is to act diligently in accordance with the technical and professional standards required by the service offered. There is a requirement to carry out the task or tasks carefully, thoroughly and on time.

Where appropriate you should make clients and employers aware of any limitations in the service offered and you should refuse to carry out any tasks for which you are not technically competent.

A breach of duty of care can occur where you are trying to carry out tasks without checking your facts and figures, either through negligence or through a lack of time.

A breach of professional competence will occur where you are trying to carry out tasks for which you have little knowledge or where you have not kept up to date with recent developments. For example, you must not offer tax as a service if you haven't studied tax for the past five years. Similarly, you must refuse to carry out tasks on inheritance tax if you haven't studied inheritance tax.

Confidentiality

An accountant has a responsibility to act in the client's (or employer's) best interest. This cannot be achieved if the client (or employer) believes that the information given to the accountant will be shared with others. Therefore an accountant has a duty not to disclose any confidential information acquired as a result of professional and business relationships without the specific authority of the client (or employer). An accountant must also refrain from using confidential information for personal gain.

The duty of not disclosing confidential information is not confined to customers, clients, suppliers and managers. You should take steps to ensure that this information is not accidentally disclosed in social situations or to family members. For example, you must take care not to talk about a business's affairs at the gym, restaurant, or on family outings. Even sharing information with work colleagues can be a breach of confidentiality.

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Confidential information can take many forms. For example, you may find out that your directors are considering taking over a competitor, or you may know the phone number of your manager. It doesn't matter how material the information is, you must still keep the information secure and private.

You should take care that you do not disclose information inadvertently. You should never reveal information over the telephone or on social media. You can't be sure who will see or hear the information. There are also organisations that collect information for statistical purposes. Never reveal information to marketing and data collection agencies without the express permission of the client or employer.



The principle of confidentiality continues even after the individual has left the employment or after the relationship with the client has ended. You cannot go to a new job and tell the new employer confidential information about your previous employment.

There are occasions where disclosure of confidential information is permitted. There are broadly three situations where disclosure is permitted.

1. When the client has given permission. An example might be when a client wishes to obtain a loan and the bank or lender has asked for certain financial information from the client. The accountant may be given permission to disclose this information on behalf of the client. An accountant will also need the consent of the client to reveal information to HMRC in any tax matters. However, the consent must be explicit and an accountant would be wise to get the permission in writing.
2. When there is a legal duty to disclose the information. An example might be when the accountant suspects the client is committing fraud. The Fraud Act 2006 states that disclosure of such information is a legal requirement.
3. When there is a professional duty to disclose information. An example might be to protect the professional interests of a professional accountant in legal proceedings. There may also be a public interest reason for disclosing information. An example might be where the client's activities will cause substantial environmental damage.

Keeping personal data confidential is required by law under the Data Protection Act. This Act was covered at the Foundation Level of the AAT course.

Professional Behaviour

Accountants have an obligation to comply with relevant laws and avoid any actions that will bring the accounting profession into disrepute. Accountants must not take part in any 'shady' deals, and they must not 'bend the rules' to accommodate their line manager's wishes.

Professional behaviour extends to how you portray yourself as an accountant. You cannot say you are a chartered accountant if you are not. You must also be careful when marketing your business. Advertising material must be truthful and should not make exaggerated claims. Advertising should not make disparaging references or unsubstantiated comparisons with other businesses. You cannot say that you will guarantee to reduce the client's tax bill because this will depend on the client's previous financial activities. You can say that you will ensure the client will pay only what is due.

You cannot say that you are better than the rest. You don't state what exactly you are better at, and in any case, you don't have any substantiated evidence that you are better than the rest.

(Note: basically, the difference between integrity and professional behaviour is that integrity is to do with your professional work and professional behaviour is to do with your general overall behaviour.



The PCRT has specific advice for advisors.

“It will normally be assumed that facts and information on which business tax computations are based were provided by the client or employer as the taxpayer, and the latter bears ultimate responsibility for the accuracy of the facts, information and tax computations.”

This means that the taxpayer has the ultimate responsibility for submitting a correct tax return. The advisor must make the client aware of this.

“When a member learns of a material error or omission in a tax return of a prior year, or of a failure to file a required tax return, the member has a responsibility to advise promptly the client or employer of the error or omission and recommend that disclosure be made to HMRC.

If the client or employer, after having had a reasonable time to reflect, does not correct the error, the member shall inform the client or employer in writing that it is not possible for the

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member to act for them in connection with that return or other related information submitted to the authorities.”

When a member (i.e. an AAT registered accounting technician) learns of an error or omission, they must bring this to the attention of the taxpayer and advise that it must be disclosed to HMRC. If the taxpayer refuses, the client should notify them in writing that they can no longer act for them.

Money laundering is the term used to describe the process by which criminals disguise the proceeds of criminal conduct by making such proceeds appear to have come from a legitimate source. As a member of the AAT (even student members), the tax advisor is in the regulated sector. This means that they have extra responsibilities to report suspicious activities. If they suspect Money Laundering, they MUST report this to the Money Laundering Reporting Officer (MLRO) if they work within a business, or directly to the National Crime Agency (NCA) if they are a sole practitioner. The advisor needs to consider this when clients refuse to disclose errors or omissions. The advisor must not tell the client that they have been reported as this is also an offence. If the advisor does tell the client, they are at risk of a further offence of ‘tipping off’. (The principle of confidentiality does not apply in these circumstances as there is a legal responsibility to disclose the information.)

Readers who are intending to become tax advisors would be well advised to read the Consultative Committee of Accountancy Bodies’ guidance on anti-money laundering, so they are aware of the rights and responsibilities of a tax advisor. This guidance can be found at <https://www.ccab.org.uk/wp-content/uploads/2020/09/AMLGuidance2020.pdf>

Chapter Summary

- Taxation is used by the government to raise money for public services, to control the economy and to control public behaviour.
- Taxation should be fair, clear, convenient and efficient.
- HMRC is the government office which administers and collects tax.
- The tax laws are created in parliament by the government using various pieces of legislation.
- The tax year for sole traders and partnerships runs from 6th April to the following 5th April.
- The tax year for limited companies runs from 1st April to the following 31st March.
- Tax can be evaded, or avoided. Evasion is illegal. Abusive avoidance schemes can be rejected under GAAR rules.
- Tax advisors must act ethically when dealing with tax matters.

Practice Questions

Chapter 1

1.1

Which of these taxes is an individual likely to pay on their earnings from self-employment?

Tax	✓
Income Tax	
Corporation Tax	
Capital Gains Tax	
National Insurance	

1.2

Which of these taxes is a limited company likely to pay on its profits?

Tax	✓
Income Tax	
Corporation Tax	
Capital Gains Tax	
National Insurance	

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1.3

Which of these statements are correct?

Statement	√
The Finance Act 2023 applies to the period 6 th April 2022 to 5 th April 2023	
The tax year for sole traders run from 1 st April to the following 31 st March	
The financial year for limited companies run from 1 st April to the following 31 st March	
The Finance Act 2023 applies to the period 6 th April 2023 to 5 th April 2024	

1.4

Match the correct description to each of the following documents/statements.

Statement	
Provides guidance on how HMRC may be prepared to not apply the strict letter of the law in certain circumstances.	
Provides HMRC's interpretation of the law and how it will be applied.	
Provides the detail of what is set out in the Act.	
Provides interpretation of the law in a court.	

Select from: Statutory Instrument, Case Law, Statement of Practice, Extra-statutory Concession

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1.5

Gecko Ltd's Chief Accountant has identified three ways in which the company could pay less tax in 2023-24. For each, identify whether it is likely to be regarded as tax planning, tax avoidance or tax evasion.

	Tax Evasion Tax Avoidance Tax Planning
Not include a number of sales invoices from the last week of the financial year to reduce the turnover for the year.	
Open an offshore bank account in a country with a lower rate of Corporation Tax than the UK.	
Ensure the company claims all the allowances it is entitled to in respect of purchases of plant and machinery in the year, thereby reducing its profits	