The Voice of Business Services

Rt Hon. George Osborne, M.P.,
Chancellor of the Exchequer,
H.M. Treasury,
1 Horse Guards Road,
London.
SW1A 2HQ

December, 2010

Dear Chancellor,

Following on from this year's Emergency Budget and the subsequent Comprehensive Spending Review, and ahead of the 2011 Budget, we thought it would be helpful to submit our reflections on the current environment at the end of what has been an exceptional economic and political year. This letter is part of our ongoing dialogue with the Treasury.

The business and outsourced service industry is one of the largest sectors in the UK and plays a significant role in delivering training, employment, and economic growth. It helps to drive innovation, choice and diversity, as well as improving efficiency.

Three-quarters of the industry's work is business to business, with the remaining quarter providing services to the public sector. The BSA is the only body dedicated to representing the industry as it operates across the private and public sectors. We promote the industry and the positive contribution it makes to the economy.

Economic conditions continue to be challenging but the industry is well equipped to respond in a flexible and innovative way and there is clear evidence that both the private and public sectors have used it to help respond to the challenges they continue to face.

As businesses BSA members are a significant part of 'corporate Britain'. As such we would be concerned by any move that would make us less domestically or internationally competitive. Maintaining as stable and competitive a rate of corporation tax as possible must remain a priority for the Government.

In this prevailing austerity failure to optimise the benefits of outsourcing is a mistake. So too is discussion of public sector reform which fails to recognise the potential of this dynamic and mature service industry. The entire rationale of outsourcing is to perform a function in a better and more efficient way than a client organisation could do itself. A competitive market to provide these functions means investment in innovation and training is fundamental. This investment drives growth through the rest of the economy.

As an industry, we are beyond the simple dichotomy of public versus private provision. The goal should be to inject the best of the commercial world into the provision of public services – and vice versa. Outsourcing is not a magic bullet to the UK's fiscal challenge, but the industry is part of the solution.

We appreciate the willingness and co-operation your officials continue to show in meeting with us to discuss and respond to the points we raise.

Yours sincerely,

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Introduction

In our previous submission we acknowledged that the Government's objective of significantly reducing the budget deficit will result in greater pressure on the pricing of contracts for public related services. The business services sector, that delivers many of these public services contracts, is characterised by low margins and keenly priced contracts. It is important that margins are maintained at a reasonable level for our members whilst allowing the government to meet public service demands at an acceptable level of cost.

Certainty over the future profile of UK taxes is important to enable our members to price contracts competitively and this is particularly important given the long duration of most public sector contracts. We therefore welcome the publication of the paper on Corporate Tax Reform[1] and the five principles set out in the paper[2] that are designed to give businesses certainty on tax and to provide a clear and consistent direction for reform. We also welcome the comments in the paper that reforms of other areas of tax (e.g. personal and environmental taxes) will be approached in a way that is consistent with these principles.

Clearly there is still much uncertainty on several areas of corporation tax e.g. CFCs, R&D tax relief and the treatment of intellectual property. Our members believe that it is important that any new proposals allow for sufficient consultation on the changes so that businesses can understand and plan for the impact of the changes and also have the opportunity to comment and put forward suggestions for amendments. We therefore welcome the Government's commitment to extensive and timely review of future reforms with business.

Comprehensive Spending Review ('CSR')

The announcements in the CSR mean that the activities of the public sector will need to change to support the cost saving agenda. For the business services sector this creates the following potential issues:

- Whether there is a need to consider changing the existing tax exemptions which apply to the public sector to remove distortions of competition between the public and private sectors. Our members have an important role to play in delivering the cost and efficiency savings but should not be unfairly penalised compared to a public body that could perform the same service without being subject to tax. Indeed, such distortions could potentially be a dis-incentive for some within the business services sector with negative consequences for the wider economy

- Members looking to enter into joint ventures with the public sector will face new issues and complexities depending on how the public sector body is treated for tax purposes. This may have a knock-on effect for contract pricing. As above, there is likely to be a need to consider legislating to deal with such situations.

Our members believe that this is an area which will evolve as both sectors adapt to the challenges. As issues and problems are identified we would urge the Government to be receptive to acting quickly and pragmatically to ensure tax does not become a barrier to achieving wider policy aims.

[1] Corporate Tax Reform; delivering a more competitive system
[2] Corporate Tax Reform; delivering a more competitive system, Chapter 2

Corporation tax

UK tax competitiveness and corporation tax rate

The Government has stated its aim of creating the most competitive corporate tax regime in the G20. To achieve this, the corporation tax rate will reduce to 24 percent. Our members consider that this is quite competitive compared to many countries, but because of the phasing of the reduction, the rate does not reduce this far until 2014 at which time other countries may have equally reduced their rates. In principle our members welcome the Government's strategy to prioritise rate reductions over introducing or broadening reliefs as this gives our members confidence in forecasting corporation tax liabilities when pricing their contracts. However, we highlight below some areas where deviating from this strategy would be beneficial.

We also welcome the Government's intention to move the UK tax system towards a more territorial based approach. This should allow our members to structure and carry out their international operations in the way that makes the best commercial sense without having to worry about the tax distortions which can currently arise (e.g. under the CFC rules) which can inhibit competitiveness.

Interest Deductibility

The BSA fully supports the Government's decision not to pursue significant changes to the existing rules for interest deductibility. We agree that designing a new system for interest deductions that was fair and workable for all businesses would lead to undue complexity and uncertainty as well as undermining the competitive advantage of the existing regime which does not significantly restrict relief for interest expense.

Capital allowances

As low margin businesses, capital allowances are very valuable to our members. The sector is therefore adversely impacted by the reductions in capital allowance rates which were announced in the June 2010 budget, but do however acknowledge that the reductions were not as penal as had been feared.

We urge the government to maintain a commitment to Enhanced Capital Allowances ('ECA's') for energy efficient and environmentally friendly plant and machinery. Companies demands for energy efficient technology will develop and increase over time and, in addition, as companies move out of recession they will be looking to invest in new equipment. In our view ECA's should continue as a long term tax allowance which encourages investment in green technology. This also fits well with the Government's commitment to tackling climate change. We therefore consider that this is one area where some flexibility on the principle of 'no introduction or broadening of reliefs' would be welcome.

CFC reform

Our members welcome the general principles for CFC reform as set out in the Corporate Tax Reform paper, which focuses on overseas profits that have been artificially diverted from the UK. However, much will depend on the detail. Until the proposals are available in a more detailed and finalised form there will be continued uncertainty which often makes it difficult for our members to plan and manage their overseas businesses. As noted above, uncertainty over tax also has an impact on contract pricing and hence clarity over the new rules is required as soon as possible. We advocate a simplified regime and one which does not adversely impact business decisions on what activities should be located overseas.

Our members do welcome the introduction of the interim improvements in Finance Bill 2011, particularly the new intra-group activities exemption and the extension of the period of grace for the motive test up to a period of 3 years which will be of benefit to groups who make overseas acquisitions. We also welcome the increase in the de minimus exemption to £200,000 (for large groups) to be measured by reference to accounting profits as this will reduce the administrative burden for many of our members who are within the CFC rules.

General Anti Avoidance Rule ('GAAR')

The Government has recently introduced to a consultation to examine the potential introduction of a General Anti Avoidance Rule ('GAAR').

Our members consider that the proposal to introduce a single universal GAAR supports the objective of simplifying and reforming the tax system. However, to achieve this will also require the repeal of the various and complex specifically targeted anti-avoidance rules that already exist and we would welcome early clarification from the Government on this point.
In addition, experience of other countries that already have a GAAR is that they can be difficult to implement in practice and can actually lead to more complexity and uncertainty. It is also vital that any GAAR is accompanied by a workable clearance mechanism that is able to provide clearances on a timely basis and allows taxpayers proper recourse if a clearance is denied.

R&D tax relief

With many of our members involved in R&D activity, one tax incentive that is of particular relevance is the availability of R&D tax relief. Our members R&D activity provides a valuable contribution to the public services of this country, for example the work undertaken by our members on behalf of the Ministry of Defence or Home Office. The BSA is therefore pleased with the announcement in the Corporate Tax Reform paper that Government does not propose to restrict R&D relief to particular sectors of the economy.

However, we are concerned that references in the paper to targeting relief on costs that genuinely contribute towards innovative activity could limit the scope of the relief for our members. The paper gives an example of internally developed software not being truly innovative. In a services based sector, where efficiency in the delivery of services is key, our members believe that work to improve internal systems and processes is vital in driving competitiveness and should not be considered as less innovative than R&D which benefits third parties.

VAT

A significant proportion of the BSA's membership provide services to organisations such as Government departments, financial services providers and charities which are unable to reclaim all of the VAT they are charged.

For such organisations, VAT is a major disincentive to employ otherwise efficient strategies such as outsourcing. This clearly affects business services providers and in addition, it creates a major impediment to the Government's stated policy to reduce excesses and unnecessary spending in the public sector. We therefore encourage you to consider what steps may be taken to reduce the negative impact of VAT.

VAT Rate

The VAT rate will be increased in the New Year. Parts of the outsourcing industry and the business services sector in general, will be adversely affected by such an increase, for the reasons already explained. We would therefore strongly recommend that the standard-rate does not rise again, above the new rate of 20%.

VAT Reliefs

We accept that the UK VAT system must conform to EU legislation and that as such, major changes to the scope of exemption and zero-rating are not possible. However, existing reliefs should be maintained and in addition it may be possible to extend existing reliefs, such as the lower rate of VAT and to implement addition reliefs, where they are specifically allowed by the EU VAT law.

Potential areas for extended or additional relief are considered below, with key examples of how the reliefs may be structured. There may be further opportunities in addition to the examples given and the BSA would be pleased to work with you to identify how best these reliefs can be targeted and refined to provide maximum benefit.

Cost sharing exemption

Article 132(1)(f) of the Principal VAT Directive provides an exemption for certain services provided within cost sharing groups whose members carry out exempt or non business activities.

The broad purpose of the exemption is to allow organisations with exempt or non-business activities (including charities) to come together to form cost-sharing groups whose members are not burdened with VAT on the shared services. This is particularly relevant now as organisations are looking to work together to achieve economies of scale to address the current economic situation.

Although the UK has not yet adopted this exemption, it has been implemented by a number of other EU member states. It is a measure that reduces 'hidden' VAT costs for the organisations able to take advantage of it. In this way, it acts to protect jobs, aid competitiveness and achieve maximum cost efficiencies.

In summary, we consider the cost sharing exemption may provide a model to allow some relief from VAT on outsourced services and encourage partnering. Therefore, we would recommend that Government carefully considers the option of introducing this exemption at the earliest opportunity. The potential beneficiaries may include charities, welfare providers, universities, the financial sector and, in turn, the business services organisations that support them.

Reduced-rate VAT – housing maintenance

HM Treasury may vary the scope of reduced-rate VAT and we recommend that such a change is considered to support the outsourcing of housing maintenance contracts. Many business services companies have maintenance contracts of this type in connection with social housing and residential care.

VAT is chargeable on these contracts at the standard-rate. However, we recommend reducing the rate payable to the lower-rate of 5% in order to protect employment in this sector and to reduce the burden of VAT on the welfare housing sector in general. We note, incidentally, that this measure would be consistent with The Liberal Democrat Manifesto 2010, which under the heading 'a Green and Pleasant Land' refers to VAT measures to reduce the cost of property repairs.

Reduced-rate VAT – Labour-intensive services

Under EU law, reduced-rate VAT can also be applied to certain 'labour intensive services', including care services and the renovation and repair of private dwellings.

We strongly recommend that Government considers implementing this relief as it has the potential to reduce VAT costs on outsourcing contracts, where they fall within the labour-intensive heading.

Extra-statutory Concessions

Many business services companies are involved in the provision of elderly care and demand for these services is constantly increasing.

The current situation whereby labour cost attracts standard rate VAT for support services makes outsourcing in this sector commercially non-viable. A concession on support services in care homes would increase the commercial viability of outsourcing both catering and support services. The majority of Care Home providers are set up as charities and therefore are not able to reclaim VAT making any VAT chargeable a real cost to the business. Where external providers operate on an agency basis there is currently a concession that catering labour is not standard rated for VAT, this does not currently apply to support services. A VAT concession on support services in the care sector would increase private sector involvement and innovation.

Green Taxes

In its Coalition Document earlier this year the Government announced its intention to generate a greater percentage of tax revenues through green taxes. It is disappointing that six months on there has been a lack of development in this area. It is also not clear what this will involve, for example does this include the Carbon Reduction Commitment or are other new taxes to be introduced? This continued uncertainty is unhelpful and we would welcome clarification.

However, on a more positive note the BSA welcomes the acknowledgment in the recent Corporate Tax Reform paper that Green Taxes also have an impact on business decisions and behaviour and therefore play an important role in the creation of the UK as a competitive tax regime.

At present there are various separate regimes which are designed to encourage environmentally friendly behaviour, or discourage environmentally-damaging behaviour, by companies. The various regimes do not result in consistent treatment between companies. As part of any future proposals to increase and/or extend green taxes, the BSA would recommend comprehensive review of the various separate regimes that exist with a view to establishing a consistent strategy and approach which both encourages 'green' behaviour as well as penalises practices that are not environmentally friendly. The BSA would also wish to see full consultation on any new Green taxes or tax incentives in order to avoid unintended consequences and reduce the risk that such mechanisms do not achieve their policy aims.

The BSA would also welcome measures which further encourage the right behaviour. Although running counter to the broad strategy set out in the Corporate Tax Reform paper, an example would be extending the availability of R&D tax relief for expenditure on processes which reduce carbon emissions, in cases where this may not meet the existing definitions required to secure the relief.

On a more general point, and related to the comment above about the creation of the UK as a competitive tax system, our members consider that the current split of the various different environmental/green regimes between different Government departments (e.g. DECC, HMRC) and the absence of an over-arching strategy under a common leadership does not help foster commitment within the business community to treat Green Taxes as a real business issue. The absence of a co-ordinated approach also creates an administrative burden for businesses that need to collate and report information under different systems.

Employee Taxes

50% income tax rate

We have previously voiced our concern that the introduction of the 50% tax rate reduces the ability of the business services sector (whose main market base is the UK) to attract highly qualified and experienced staff compared to other sectors with more international operations who can offer employees the ability to -locate in outside the UK. This has the potential to create a 'brain drain' within the sector as talented individuals seek employment in other sectors where they can re-locate in countries with more favourable personal tax regimes. We would therefore welcome a commitment from the Government that they will consider reducing the rate when the current economic environment has improved.

Increased NIC rate

Our sector employs a large number of individuals on lower incomes and we are therefore disappointed that the increase in employer Class 1 National Insurance Contributions has been introduced with no exemption for employees on low incomes who can least afford the increase. We would therefore encourage a reduction in the national insurance increase for employees and in particular those on low incomes.

Pensions tax relief restrictions – significant increase in employer burdens

We welcome the Government's shift from the complexity of the previous proposals to restrict relief for pension contributions in favour of the simplified approach of the new annual allowance of £50,000. However, at a time when companies are embarking on large redundancy programmes in order to cut costs we are concerned that the new rules will penalise individuals who wish to use their redundancy payments to fund their pension schemes. As a compromise we would urge the Government to consider increasing the £50,000 restriction on the carry forward of unused allowances from the 2008/09 to 2010/11 periods.

IR 35 proposed review

With our members looking to cut costs some will be considering more flexible working arrangements including increasing their use of contractors. Our members therefore have a vested interest in the proposed review of the current intermediaries' legislation known as IR35. Our members welcome this as the IR35 legislation is cumbersome and open to interpretation, as evidenced by various tribunal cases on the subject. We agree that the prevention of tax avoidance is important and look forward to the proposal to simplify this area and to allow contractors and end user to have more certainty on the position.

Salary Sacrifice

With our members facing tighter margins on contracts they are all considering ways to reduce employee costs. Salary sacrifice arrangements are one way to achieve this whilst having the added advantage of improving employee relationships. We request that HMRC provide further guidance on their interpretation of the tax exemptions often relied upon to deliver tax and NIC free benefits under a salary sacrifice arrangement.

Disguised remuneration

Legislation will be introduced in the Finance Bill 2011 in relation to "employment income through third parties". Although the guidance focuses on disguised remuneration the effects of the proposed legislation is far reaching. Further clarity is sought from HMRC on how they will interpret the legislation and how it will impact the business services sector.