

# CHAPTER 1: INTRODUCTION TO THE UK TAX SYSTEM

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## LEARNING OUTCOME

At the end of the chapter, you should be able to:

- TLO A1a** : **Describe** the purpose (economic, social etc.) of taxation in a modern economy.
- TLO A1b** : **Explain** the difference between direct and indirect taxation.
- TLO A1c** : **Identify** the different types of capital and revenue tax.
- TLO A2a** : **Describe** the overall structure of the UK tax system.
- TLO A2b** : **State** the different sources of revenue law.
- TLO A2c** : **Describe** the organisation HM Revenue & Customs (HMRC) and its terms of reference.
- TLO A2d** : **Explain** the difference between tax avoidance and tax evasion, and the purposes of the General Anti-Abuse Rule (GAAR).
- TLO A2e** : **Appreciate** the interaction of the UK tax system with that of other tax jurisdictions.
- TLO A2f** : **Appreciate** the need for double taxation agreements.
- TLO A2g** : **Explain** the need for an ethical and professional approach.



## Introduction

Welcome to UK taxation Finance Act 2019 paper UK TX F6. The UK taxation is based on a complex system. Let's first focus on the purpose of **raising taxes** and also on the **economic, social** and **environmental factors**. After that, we will focus both on **revenue** and **capital**, the **direct** and **indirect taxes**, then we will move on to the administration of tax in the UK.

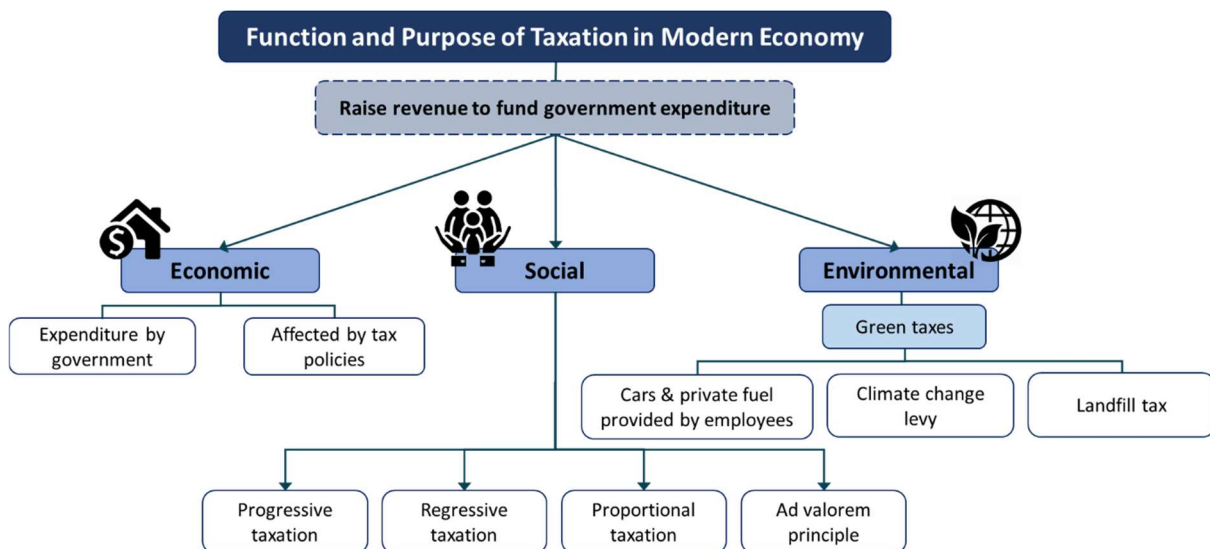
The UK tax system also interacts with overseas **tax jurisdiction**, and in addition we will be looking at the differences between **tax avoidance** and **tax evasion**, then we will be explaining the professional and ethical approach in dealing with tax. Finally, we will be looking at the situation where a client has failed to disclose information to the HMRC.

### 1.1 Functions and Purposes of Taxation in a Modern Economy

#### Learning Outcome (ACCA Study Guide Area A)

**A1a: Describe** the purpose (economic, social etc.) of taxation in a modern economy.

Diagram 1.1: Functions and Purposes of Taxation



### 1.1.1 Economic Factors

Spending by the government and the system of **taxation impacts on the economy of a country**. Taxation policies have been used to influence economic factors such as employment levels, inflation and imports/exports. Taxation policies are also used to direct economic behaviours of individuals and businesses. For example, they encourage individual saving habits (Individual Savings Accounts, savings income and dividend income nil rate bands) and giving to charity (Gift Aid Scheme).

Furthermore, they may:

- discourage motoring (fuel duties)
- smoking & alcohol (duties and taxes)
- environmental pollution (landfill tax)

As government objectives change, **taxation policies** may be altered accordingly.

### 1.1.2 Social Factors

The taxation system accumulates and redistributes wealth within a country. Different taxes have different social effects:

Table 1.1.2: Social factors

Social Factors	
<b>Progressive Taxation</b>	As income rises, the proportion of taxation raised also rises (e.g., UK income tax)
<b>Regressive Taxation</b>	As income rises, the proportion of taxation paid falls. For example, tax on cigarettes is the same regardless of the level of income of the purchaser, so as income rises it represents a lower proportion of income.
<b>Proportional Taxation</b>	As income rises, the proportion of tax remains constant. (e.g., Latvian/Lithuanian income tax)
<b>Ad Valorem Principle</b>	A tax calculated as a percentage of the value of the item. (e.g., Value Added Tax)

### 1.1.3 Environmental Factors

These are the examples relating to environmental factors.

Table 1.1.3: Environmental factors

Environmental Factors	
<b>Lease of Purchase of Cars</b>	The taxation of cars is based on carbon dioxide emission (CO <sub>2</sub> ). The purpose of this is to encourage businesses to buy low emission cars to reduce emission into the atmosphere. As an incentive, a higher rate of capital allowance is given.
<b>Climate Change Levy</b>	To protect the environment from being polluted, climate change levy has been introduced to businesses in proportion to their consumption of energy. The aim is to encourage reduced consumption.
<b>Landfill Tax</b>	Landfill tax is being imposed on operators of landfill sites on each ton of rubbish and waste dumped. Its aim is to encourage recycling.



#### Check Understanding

#### Topic 1.1: Functions and purposes of taxation in a modern economy

#### Learning Outcome (ACCA Study Guide Area A)

**A1a: Describe** the purpose (economic, social etc.) of taxation in a modern economy.

#### Question:

What are the purposes of taxation in a modern economy?

**1.2 Different Type of Taxes**

**Learning Outcome (ACCA Study Guide Area A)**

**A1b: Explain** the difference between direct and indirect taxation.

**A1c: Identify** the different types of capital and revenue tax.

**Diagram 1.2: Different Types of Taxes**

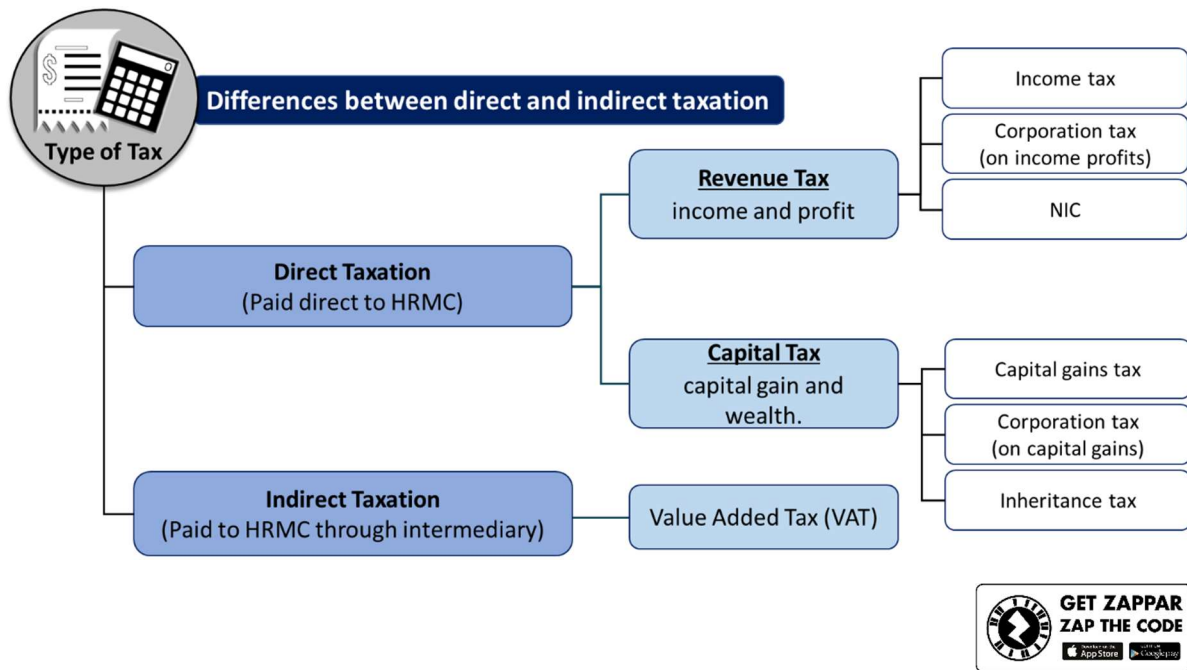


Table 1.2 Types of Taxes (UK)

Type of Tax	Payable by
Income Tax	Individuals on most income
National Insurance Contributions	<ul style="list-style-type: none"> <li>Individuals who are employed/self-employed</li> <li>Businesses in relation to their employees</li> </ul>
Capital Gains Tax	Individuals on the disposal of capital assets
Inheritance Tax	Individuals on lifetime and death transfers of assets
Corporation Tax	Companies on income and chargeable gains
Value Added Tax	Final consumer on purchases of most goods and services

### 1.2.1 Direct Taxation

#### a) Revenue Based Tax

These are taxes paid directly to the Government based on income and profit.

Examples are:

- Income tax
- Corporation tax (on income profits)
- National insurance contribution

#### b) Capital Based Tax

These are taxes based on capital gain and inherited wealth.

Examples are:

- Capital gains tax
- Corporation tax (on capital gains)
- Inheritance tax

### 1.2.2 Indirect Taxation

Taxes are collected via an intermediary who passes them on to the government. For example:

- VAT where the consumer pays VAT to a supplier trader, and the trader then pays it to the government.



#### Check understanding

#### Topic 1.2: Different types of taxes

#### Learning Outcome (ACCA Study Guide Area A)

**A1b:** Explain the difference between direct and indirect taxation.

**A1c:** Identify the different types of capital and revenue tax.

#### Question 1:

What are the differences between direct and indirect taxation?

#### Question 2:

What are the types of capital and revenue tax?

**1.3 Principal Sources of Revenue Law and Practice**

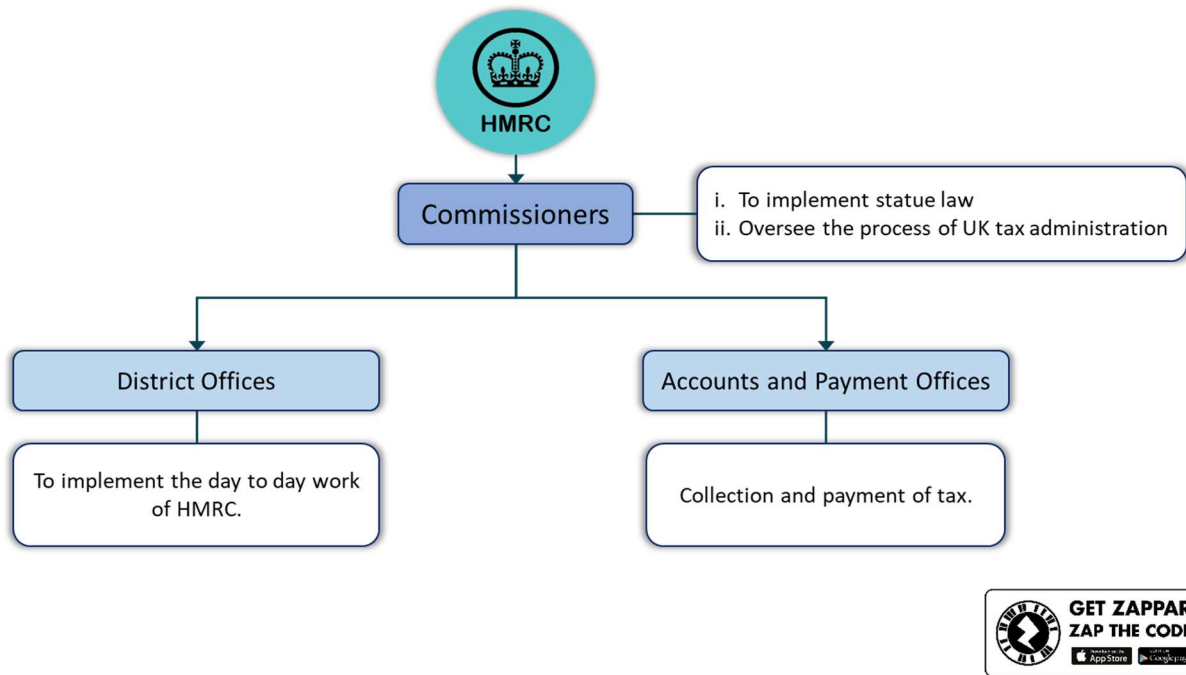
**Learning Outcome (ACCA Study Guide Area A)**

**A2a: Describe** the overall structure of the UK tax system.

**A2b: State** the different sources of revenue law.

**A2c: Describe** the organisation HM Revenue & Customs (HMRC) and its terms of reference.

**Diagram 1.3.1 Structure of the UK Tax System**



**1.3.1 Structure of the UK Tax System**

**HM Revenue and Customs (HMRC)**

The treasury formally imposes and collects taxation. The management of the treasury is the responsibility of the Chancellor of the Exchequer. The administration function for the collection of tax is undertaken by HMRC.

**Commissioners**

The head of HMRC are the commissioners whose duties are:

- i. to implement statute law
- ii. oversee the process of UK tax administration

The main body of HMRC is divided into **district offices** and **accounting and payment offices**.

**District Offices**

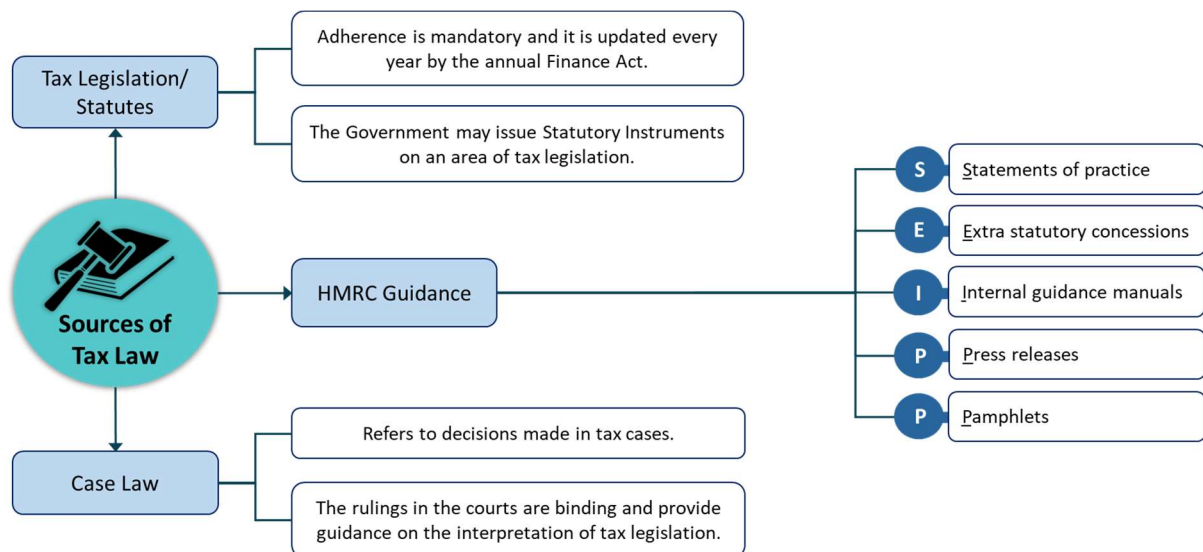
The Commissioner appoints officers of HMRC to implement the day to day work of HMRC.

**Accounts and Payment Offices**

These concentrate on the collection and payment of tax.

### 1.3.2 Sources of Tax Law

Diagram 1.3.2 Sources of Tax Law



The sources of tax law are obtained via Acts of Parliament, Statutory Instrument and case law.

#### Tax Legislation/Statutes

Adherence is mandatory. It is updated every year by the annual Finance Act. The Government may issue Statutory Instruments which are detailed notes on an area of tax legislation.

#### Case Law

This refers to decisions made in tax cases. The rulings in the courts are binding and so provide guidance on the interpretation of tax legislation.

#### HMRC Guidance

This is issued due to the complexity of the legislation:

- (a) Statements of practice - sets out how HMRC intend to apply the law
- (b) Extra statutory concessions – sets out circumstances in which HMRC will not apply the strict letter of the law where it would be unfair
- (c) Internal guidance manuals – HMRC’s own manuals which are available to the public
- (d) Press releases – provide details of a specific tax issue. For example, used to communicate the information stated in the annual budget
- (e) Pamphlets - provide explanations of various tax issues in non-technical language





## Check understanding

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### Topic 1.3: Principal Sources of Revenue Law and Practice

#### Learning Outcome (ACCA Study Guide Area A)

**A2a:** Describe the overall structure of the UK tax system.

**A2b:** State the different sources of revenue law.

**A2c:** Describe the organisation HM Revenue & Customs (HMRC) and its terms of reference.

#### Question 1:

Describe the overall structure of the UK tax system.

#### Question 2:

What are the sources of revenue law?

#### Question 3:

What are the terms of reference of the organisation HM Revenue & Customs (HMRC)?

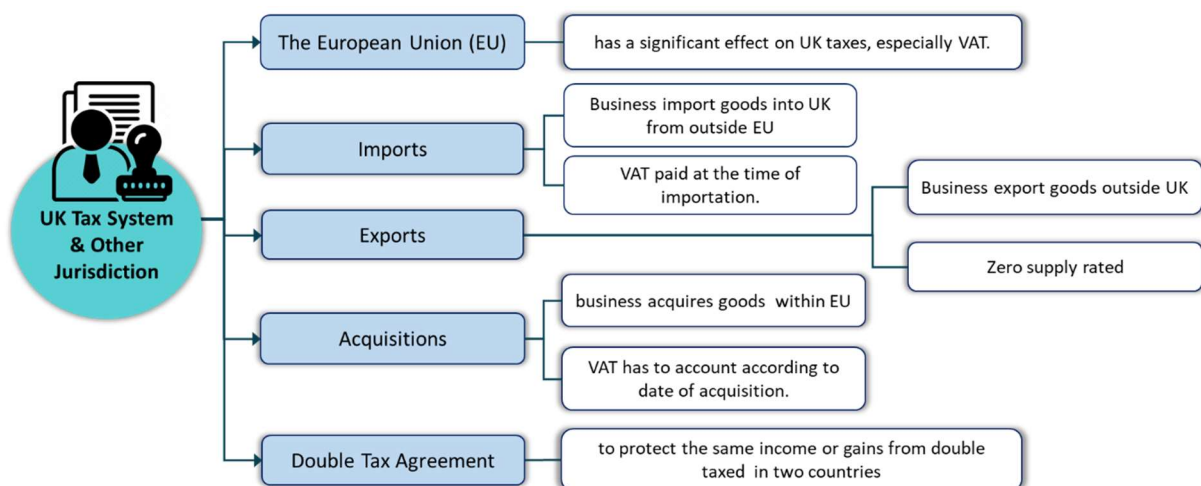
## 1.4 The Interaction of the UK Tax System with that of other Tax Jurisdictions

### Learning Outcome (ACCA Study Guide Area A)

**A2e: Appreciate** the interaction of the UK tax system with that of other tax jurisdictions.

**A2f: Appreciate** the need for double taxation agreements.

Diagram 1.4: The Interaction of the UK Tax System with that of other Tax Jurisdictions



### 1.4.1 The European Union (EU)

UK membership of the European Union (EU) has a significant effect on UK taxes, especially VAT.

### 1.4.3 Imports

Overseas suppliers outside the European Union are called 'imports'. When a UK VAT registered business import goods into the UK from outside the European Union, VAT must be paid at the time of importation.

### 1.4.5 Exports

Goods sold to customers who are outside the European Union will be called exports. When a UK VAT registered business export goods into the UK from outside the European Union, then the supply is zero-rated. Supplies of services from outside the European Union are outside the scope of VAT.

### 1.4.7 Acquisitions

Overseas suppliers within the European Union are called 'Acquisitions'. When a UK VAT registered business acquires goods from within the European Union, then the VAT has to be accounted for according to the date of acquisition.

### 1.5.1 Double Tax Agreement

Double tax agreement is designed to protect the same income or gains from being taxed in two countries. This is avoided by means of double tax agreement.



## Check understanding

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### **Topic 1.4: The Interaction of the UK Tax System with that of Other Tax Jurisdictions**

#### **Learning Outcome (ACCA Study Guide Area A)**

**A2e: Appreciate** the interaction of the UK tax system with that of other tax jurisdictions.

**A2f: Appreciate** the need for double taxation agreements.

#### **Question 1:**

What are the interactions of the UK tax system with that of other tax jurisdictions?

#### **Question 2:**

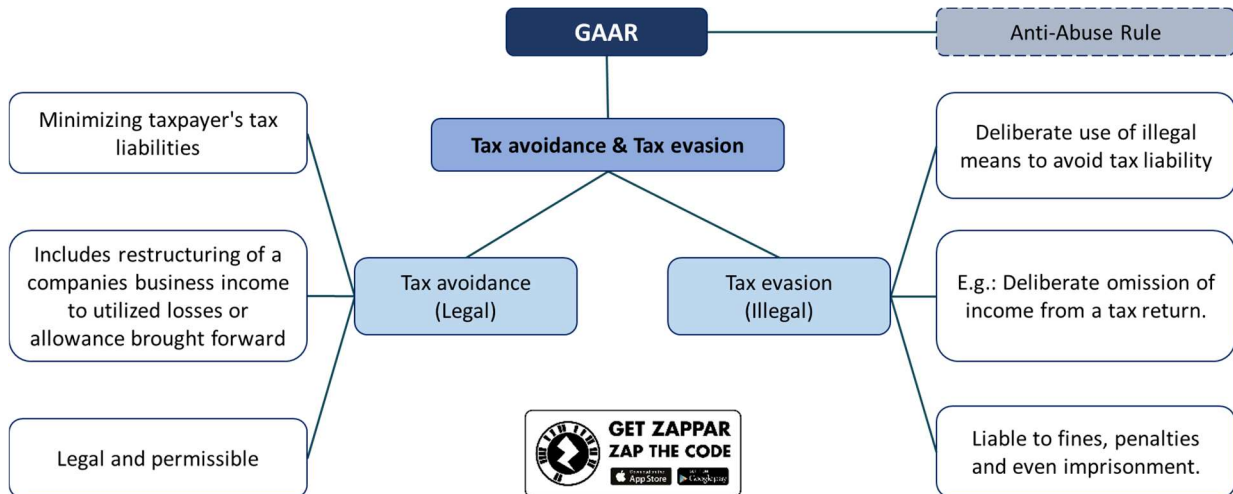
What are the need for double taxation agreements?

## 1.5 Tax Avoidance and Tax Evasion

### Learning Outcome (ACCA Study Guide Area A)

**A2d: Explain** the difference between tax avoidance and tax evasion, and the purposes of the General Anti-Abuse Rule (GAAR).

**Diagram 1.5: Tax Avoidance and Tax Evasion**



### 1.5.1 Tax Evasion

Any action taken to evade taxes by illegal means. For example:

- (a) Suppressing information - failing to declare taxable income to HMRC.
  - (b) Providing false information - claiming expenses that have not occurred
- Tax evasion carries a risk of fines and/or imprisonment.

### 1.5.2 Tax Avoidance/ Purposes of the General Anti-Abuse Rule (GAAR)

Any legal method of reducing your tax burden. For example, taking advantage of an Individual Savings Account, making best use of available allowances, exemptions and reliefs, or spouses and civil partners dividing ownership of income producing assets to avoid higher rates of tax and enjoy lower rates of tax.

The term is also used to describe tax schemes that utilise loopholes in the tax legislation.

HMRC have introduced new disclosure obligations regarding Disclosure of Tax Avoidance Schemes (DOTAS) and a "General Anti Abuse Rule" (GAAR) to back up the existing specific legislation. The rule targets abusive arrangements (action that cannot be regarded as reasonable) arising from tax arrangements designed to achieve tax advantages such as decreasing a source of income or overstating a deduction.

Must understand the purpose of these two principles to avoid paying heavy penalty and facing imprisonment.



### Check understanding

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#### **Topic 1.5: Tax Avoidance and Tax Evasion**

#### **Learning Outcome (ACCA Study Guide Area A)**

**A2d: Explain** the difference between tax avoidance and tax evasion, and the purposes of the General Anti-Abuse Rule (GAAR).

#### **Question:**

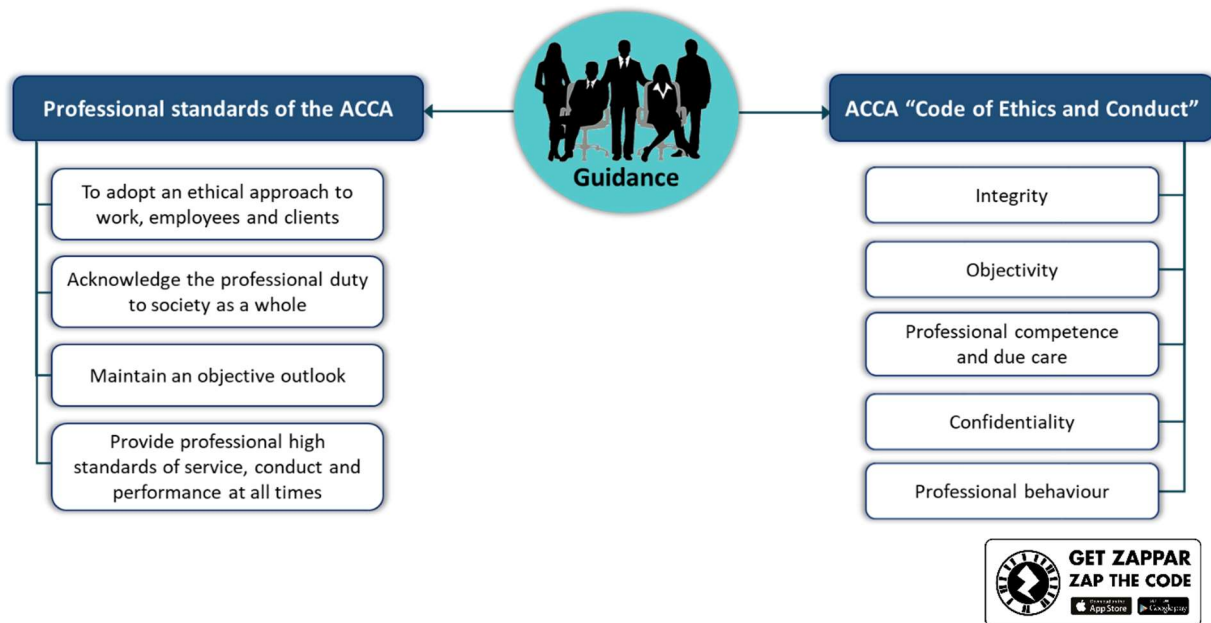
What are the difference between tax avoidance and tax evasion?

## 1.6 Professional and Ethical Guidance

### Learning Outcome (ACCA Study Guide Area A)

**A2g: Explain** the need for an ethical and professional approach.

**Diagram 1.6: Professional and Ethical Guidance**



Accountants often act for taxpayers in dealings with HMRC. Their duties and responsibilities should be towards both clients and HMRC.

### 1.6.1 Standards of the ACCA

The accountant must uphold standards of the ACCA that is:

- (a) To adopt an ethical approach to work, employees and clients
- (b) Acknowledge the professional duty to society as a whole
- (c) Maintain an objective outlook
- (d) Provide professional high standards of service, conduct and performance at all times

### 1.6.2 The ACCA "Code of Ethics and Conduct"

The ACCA "Code of Ethics and Conduct" sets out five fundamental principles which members should adhere to meet these expectations, namely:

- (a) Integrity
- (b) Objectivity
- (c) Professional competence and due care
- (d) Confidentiality
- (e) Professional behaviour



### Check understanding

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#### **Topic 1.6: Professional and Ethical Guidance**

#### **Learning Outcome (ACCA Study Guide Area A)**

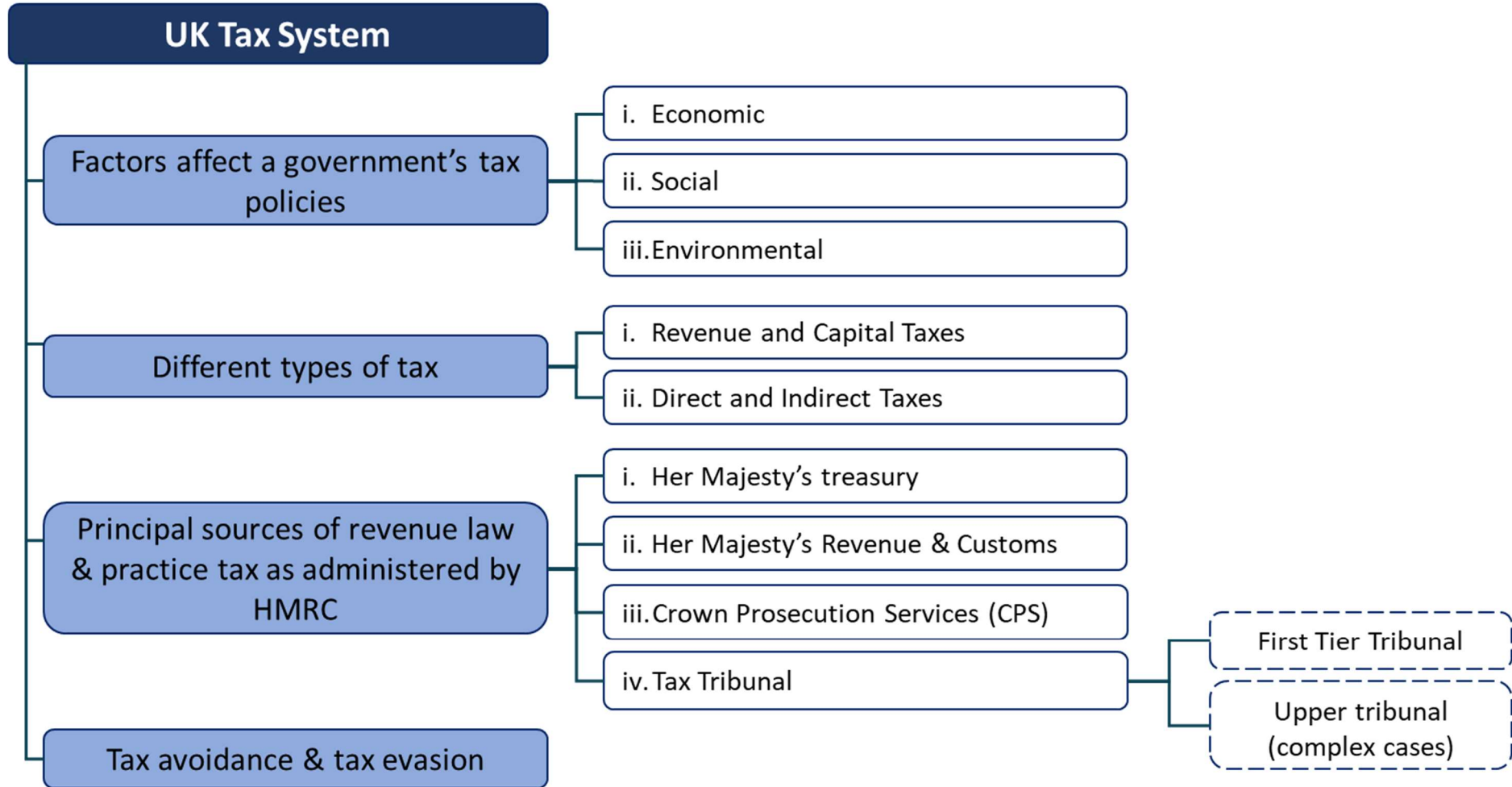
**A2g: Explain the need for an ethical and professional approach.**

#### **Question:**

What are the need for ethical and professional approach?

1.7 Chapter 1: Summary

Diagram 1.7: Summary of the Introduction to UK Tax System





## 1.8 Chapter 1 Check Understanding: Answer

### Topic 1.1: Function and Purposes of Taxation in a Modern Economy

Answer:

To provide funds or property with which to promote general welfare of its citizen and to functioning the government machineries.

### Topic 1.2: Different Type of Taxes

Answer 1:

Direct taxes are non-transferable taxes paid by the tax payer to the government and indirect taxes are transferable taxes where the liability to pay can be shifted to others. Income Tax is a direct tax while Value Added Tax (VAT) is an indirect tax.

Answer 2:

- Capital tax are taxes based on capital gain and inherited wealth. i.e capital gains tax, Corporation tax (on capital gains) and Inheritance tax.
- Revenue tax are taxes paid directly to the Government based on income and profit. i.e Income tax, corporation tax (on income profits) and National insurance contribution.

### Topic 1.3: Principal Sources of Revenue Law and Practice

Answer 1:

UK tax system control by Her Majesty's Revenue and Customs (HMRC)

There are 4 main important roles under HMRC. The treasury formally imposes and collects taxation. The Commissioners act to implement statute law and oversee the process of UK tax administration.

District Offices to implement the day to day work of HMRC. Lastly, accounts and payment Offices whose concentrate on the collection and payment of tax.

Answer 2:

The sources of tax law are obtained via Acts of Parliament, Statutory Instrument and case law

Answer 3:

HRMC reference may come from statements of practice, Extra statutory concessions, Internal guidance manuals, Press releases and pamphlets.

### Topic 1.4: The Interaction of the UK Tax System with that of Other Tax Jurisdictions

Answer 1:

UK tax system has a significant effect on UK taxes, especially VAT. It will continue until UK leaves the EU.

Answer 2:

Double taxation agreement is designed to protect against the risk of double taxation where the same income or gains being tax in two countries.

### Topic 1.5: Tax Avoidance and Tax Evasion

Answer:

Tax avoidance is legal minimisation of tax liabilities while tax evasion is illegal

### Topic 1.6: Professional and Ethical Guidance

Answer:

If client makes a material error or omission in a tax return, or fails to file a tax return, and does not correct, omission or failure when advised, the accountant should cease to act for the client, inform HMRC of this cessation and make a money laundering report.