TAXREP 26/00

DEFERRAL RELIEF FOR SUBSTANTIAL SHAREHOLDINGS

Representation submitted in August 2000 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Inland Revenue in response to a Technical Note issued on 23 June 2000.

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DEFERRAL RELIEF FOR SUBSTANTIAL SHAREHOLDINGS

INTRODUCTION

1 In general the Tax Faculty welcomes this proposed relief. The Tax Faculty and others commented at an earlier stage of the consultation process that the absence of any relief from tax on disposals of substantial shareholdings places the UK at a competitive disadvantage as compared with other possible holding company locations.

2 Although welcome, the proposed relief is still less generous than the equivalent in a good many other countries in that it is a deferral rather than an outright exemption. Further, the proposed threshold of 30% is higher than the thresholds in equivalent reliefs in many other jurisdictions; for example we understand that the threshold for the participation exemption in the Netherlands is only 5%. It may well also turn out to be more restrictive in terms of the types of company and the types of reinvestment which qualify for the relief, though this depends in part on the outcome of the consultations.

3 Obviously there may be policy reasons for structuring the relief in this way, not just to limit the cost to the Exchequer but also to skew the relief in favour of companies which reinvest all their gains and/or are engaged in particular types of activity. Nevertheless it does mean that the UK will still be a less attractive holding company location than, say, the Netherlands. It is hard to say whether, taking account of the cost and inconvenience of operating a foreign subholding company, multinational groups will consider that the new relief is sufficient to turn the balance in favour of holding substantial investments through the UK. It seems most likely that UK-based groups will be persuaded to make much less use of foreign subholding companies (not least because of the changes to the rules for double taxation relief), but that foreign-based ones will still not see the UK as a particularly attractive base for holding their investments.

GENERAL COMMENTS

4 Before we make our detailed comments on the Note, there are three general points to be made.

5 Firstly, our welcome for the new relief is given on the understanding that what is set out in the Technical Note is the complete package. If there were any intention to withdraw other reliefs as quid pro quo for the introduction of the new one, the whole proposal would need to be reappraised. In particular there will undoubtedly be some groups which will prefer to continue to use the overseas subholding company structure, either because they do not qualify for the new relief or for other reasons. It

would be unacceptable if the Government were subsequently to make such structures ineffective (for example, by extending the Controlled Foreign Company (CFC) rules to chargeable gains) on the grounds that the new relief makes them unnecessary, when there has been no mention of any such intention during the consultation process.

6 Secondly, the rules defining the new relief must be simple and certain. They must also not involve clawback provisions which impose excessive constraints on the commercial operation of the group after the reinvestment has been made. Otherwise the relief will do nothing to make the use of UK holding companies more attractive, least of all to foreign investors who are accustomed to a different style of tax legislation in their home country. This means, above all, that there will be no point in introducing the new relief if the legislation follows, yet again, the inordinately complex and restrictive pattern established by the Enterprise Investment Scheme (EIS).

7 Thirdly, we are concerned that the consultation period allowed for this important measure has been so short. A period of just seven weeks is insufficient for a proper and full consideration of the issues, particularly as it spans the holiday period when many of those involved in this area of tax are not available to comment. We believe that the minimum consultation period should be two months and, ideally, three months. Even a three month consultation would have allowed time for consideration of the results before the Pre-Budget report in November. We note that the recent Cabinet Office proposal for a Code of Conduct on Consultation concurred with our view.

DETAILED COMMENTS ON THE NOTE

Chapter 2: The Shareholding Company

Should the deferral relief apply to close companies?

8 Yes. There is no reason in principle why the ownership of a company should make any difference to its entitlement to this relief. Many closely held groups are extremely large, and the nature of their business is indistinguishable from non-close groups. This is particularly true of foreign-owned groups, where family ownership is more common than in the UK. Equally, since it is true that the majority of close companies are relatively small, it would actually seem to be contrary to the Government's policy of encouraging small businesses to withhold this reinvestment incentive from them.

9 There are further objections to restricting the relief to close companies, in terms of the regulatory burden involved. The rules defining a close company are complex: in some cases it may be practically impossible to establish whether a company is close or not, particularly where overseas and/or trustee shareholders are involved. These problems would be even worse if additional rules were introduced to distinguish ‘large’ from ‘small’ close companies.

10 The Technical Note suggests that the concern is to prevent serial entrepreneurs from being more favourably treated if they use a corporate structure than if they invest directly, the policy behind the recent CGT changes being that some tax should always be paid. However, there seems to be nothing contrary to this policy in allowing a serial entrepreneur to use a corporate structure with the benefit of the new relief. Since it is only a deferral of tax, the tax will still be paid eventually. More to the point, perhaps, is that the relief will operate at the corporate level, so the individual will still be immediately taxable on any gains that he realises in the form of cash in his own hands.

11 In point of fact, holding his investments through a company exposes the hypothetical serial entrepreneur to an additional tier of taxation on his capital gains, so even if one of the tiers of charge is deferred by the new relief he is unlikely to see this as a particularly attractive structure. The possible exception is the entrepreneur who genuinely intends from the outset that any gains from disposal of one business will be invested in a new one rather than being withdrawn for personal enjoyment, and so on indefinitely, so that gains are never realised at the personal level and the new relief defers them indefinitely at corporate level. But surely this is exactly the sort of individual that the system should be trying to encourage.

12 We understand also that there may be concern about the possibility of individuals using the new relief to operate what is in effect an investment portfolio through a close company, on a tax-free basis. This seems rather unlikely, given the relatively high percentage shareholdings needed to qualify for the relief and the two-tier effect already mentioned, but if it is the real concern it should be possible to deal with it by much more closely targeted measures than a general exclusion of close companies.

How should the new relief apply to life insurance companies?

13 No doubt the insurance industry will comment in detail on this question. However, in principle if a life company holds an investment which is substantial enough to qualify under the normal rules, which would imply that it is of a structural rather than a portfolio nature, there seems to be no reason why it should not be entitled to the relief in the same way as any other company.

How should the new relief apply to North Sea companies?

14 Again the industry will no doubt comment. Clearly the principle of the ring fence requires that the relief should be recovered if a North Sea gain is reinvested in a new shareholding in a North Sea company, and that company subsequently changes its activities so that the shares cease to qualify as a ring fence asset. However, this could be achieved by a specific clawback rule; it is not necessarily appropriate to apply the holdover rules in full, particularly the automatic clawback after ten years, when the replacement asset is a shareholding, which is inherently non-wasting.

Chapter 3: The company in which the shares are held

Defining trading companies and holding companies of trading groups

15 The proposal that all trading companies should be qualifying companies for this purpose, with none of the complicated and sometimes irrational distinctions between one type of trade and another which are found in other reliefs, is very welcome.

16 However, neither of the two options described in paragraphs 3.10 and 3.12 respectively of the Technical Note is entirely satisfactory.

17 The problem with the first alternative, i.e. disregarding insubstantial non-trading activities, is the impossibility of defining precisely what is 'substantial'. It is true that this concept is already present in the legislation on taper relief, but exactly the same problem has been raised there and the Revenue has been unable to give any satisfactory answer. Its current position is understood to be that 'insubstantial' means under 20%, but it has been unable to say whether this should be based on asset value, turnover, or something else.

18 In the context of the new relief, very substantial investment decisions will depend on knowing whether the relief is available or not. This is a problem, not least where the necessary funds for the reinvestment may simply not be available if tax has to be paid on the disposal of the original shareholding. If an imprecise test of this sort has to be used it is essential that there should be a statutory clearance procedure to provide some level of comfort for those taking the investment decisions.

19 In principle the second option, i.e. looking through to the underlying assets, seems preferable. In particular it allows proportionate relief where the company has more than one activity, and because it is not a 'cliff-edge' test it penalises any error in applying it less severely. However, the compliance problems involved in valuing all the company's assets make this approach in its undiluted form impractical.

20 There are two possible intermediate solutions.

21 One would be to take the first option, but defining 'insubstantial' activities as meaning those which amount to less than a specified percentage of the company's business by reference to *all* of the criteria which are thought potentially relevant. There would be an element of rough justice towards any company which considered that one criterion, say asset value, was a better measure of the relative importance of its various activities than the others. However, provided that the specified percentage is a reasonably generous figure few should have any very serious grounds for complaint. The compliance burden of establishing all the various percentages would be very heavy, but would be suffered only by the relatively small number of companies which cannot be seen at a glance to fall on one side of the line or the other. Furthermore, those are precisely the ones for whom the use of 'insubstantial' without a quantitative definition is even more unsatisfactory.

22 The second alternative (which could be combined with the first) would be to say that companies with only insubstantial non-trading activities qualify for the relief in full, but that other companies still qualify for partial relief on the proportionate basis

described in paragraph 3.12. This has the advantages in principle of the paragraph 3.12 option, while avoiding the worst of the compliance problem because probably the great majority of the companies concerned would know that they were well within the threshold without having to carry out detailed calculations. There would still be a significant compliance cost for companies near or above the ‘substantial’ threshold, but again these are the ones for whom the paragraph 3.10 option is unsatisfactory anyway.

Chapter 4: The Shareholding on which the Gain arises

What interest should be used for defining ‘substantial’?

23 It is essentially a policy question whether the new relief should be concentrating on financial interest or on management control. The latter is understood to be regarded as more important, but it is difficult to provide a measure of management control which is reasonably precise and is not readily capable of being manipulated. Voting control is an even less satisfactory measure, in view of the difficulties which arise if shares have different voting rights in different circumstances and in relation to different matters. It is particularly difficult to provide a reasonable way of measuring the degree of control which can be exercised by holdings below 50%, or where intermediate companies are involved in the structure.

24 That being so, a test based on financial interests is probably a reasonable proxy even if control is really the underlying criterion. The tests in Schedule 18 to the ICTA 1988 as modified for the purposes of section 170, TCGA 1992 are familiar, even though rather complicated, and should serve for this purpose.

25 Given the rather different purpose behind the test in this case, there is a question whether (as in Schedule 18 itself) one should exclude rights attaching to fixed-rate preference shares and conversely whether one should include non-normal commercial loans. (Including such loans in the Schedule 18 calculation does not necessarily imply that they would actually qualify for the relief, though this too is a possibility as discussed below). If it is the case that control rather than financial interest is really what is to be measured, it seems most logical to ignore fixed-rate preference shares, but also to ignore loans whether normal and commercial or not. Ignoring all loans would also provide some degree of simplification.

The treatment of indirect interests in establishing whether the threshold is exceeded

26 All holdings within a group should certainly be taken into account. This involves rather more than just taking account of indirect holdings. For example if A holds 15% of C, and A's wholly-owned subsidiary B owns another 15%, both 15% holdings should qualify for the relief (assuming a 30% or lower threshold) notwithstanding that B does not actually have even an indirect interest in the shares held by A. For this purpose it does seem most logical to use the normal capital gains definition of a group.

27 However, to the extent that the group itself has an indirect holding in C, e.g. where A holds 50% of D which has another 15% of C, there seems to be no reason why this should not also be aggregated. It is true, as paragraph 4.13 of the Technical Note says, that there would be dilution of the group's influence, but the Schedule 18 calculations take account of this. Thus the shares held by A and B would be treated as parts of a 37.5% holding, so would qualify even if we now assume a 35% threshold; D's shares would of course be a separate 15% holding and would not qualify.

At what level should the threshold be set?

28 This again is a policy question, and no particular answer can be said to be correct in principle. However, what the Technical Note says in paragraphs 4.2 and 4.3 about the requirement for the shareholder to be able to influence the company's results, seems to tie in fairly closely with the concept of ‘exercise of significant influence’ as found in the Financial Reporting Standard (FRS) 9 definition of an associate and in the old Statement of Standard Accounting Principles (SSAP 1) definition of an associated company. Since the long-accepted threshold for those purposes is 20%, this seems also to be the most appropriate threshold for the new relief. It would also have the advantage of avoiding the problems which a 30% threshold involves for a reinvestment in a listed company, because of the Stock Exchange limit.

Should there be a minimum period throughout which a substantial holding must be held?

29 The relief will not be relevant to shares held as trading stock, and these will presumably also not be qualifying reinvestments. This factor alone will confine the relief to investments which are acquired with at least the intention on the part of the shareholder to hold them for long enough to increase their value by the application of his influence.Furthermore, a defined minimum holding period seems an unnecessary complication (as to which see also the next question). Any such limit would operate capriciously, and would tend to distort commercial decision-making around the crucial date.

30 Also, practically any limit would be open to criticism on the grounds that it is too long in relation to the speed of developments in modern business. Recent events in the ‘dot.com’ sector have demonstrated that the influence of the major shareholders can cause the value of a new company to increase (or decrease) hugely within a matter of days.

31 It is true that a gain which arises within a short period after the acquisition of the company may be due to general market movements, or to actions initiated by the previous owners, rather than to the influence of the new shareholder, but the same is true of gains on shares held for say two years. There is no practical way of separating out gains arising from one particular cause for special treatment.

32 In conclusion, we are not in favour of a two-year minimum holding period. If, however, there is to be a minimum holding period, a period of one year would be a reasonable compromise.

How should part-disposals out of a substantial holding be dealt with?

33 It seems right in principle that the relief should be proportionately restricted where the shares in question have not formed part of a substantial holding for the whole of the period of ownership. The other alternatives mentioned in the Technical Note are either unfair to the taxpayer or open to manipulation by him, as the Note explains. However, implementing this principle in practice without imposing an unacceptable compliance burden is extremely difficult.

34 Abandoning the pooling concept, so as to operate the apportionment by reference to the history of the shares actually disposed of, seems impracticable. It would be administratively burdensome; it would necessitate a rule to identify the shares sold with particular acquisitions, which would necessarily be arbitrary and would be open to criticism whichever of the various possibilities was chosen. It would be anomalous to test entitlement to the new relief by reference to specific identification of shares when the actual gain is being computed on a pooling basis.

35 On the other hand the method suggested in the Technical Note, using apportionment by reference to the holding period of the pool as a whole, still has serious drawbacks. The results would be seriously distorted if there had been a very small holding of the shares for a long time before the acquisition which took the total holding over the threshold. As the Technical Note suggests, this method would probably also require additional anti-avoidance rules to prevent manipulation by the use of multiple share classes.

36 One way of reducing the distortion inherent in the time apportionment method would be to modify it so that each of the various periods in the life of the pool is given a weighting proportionate to the number of shares held at the time.

37 For example suppose there is just a single class of shares, and the threshold for relief is 30%; the investor initially acquired a 10% holding; after 10 years he acquired another 15%, and after a further 2 years another 20%; after another 3 years he sells the whole investment. The actual life of the pool is 15 years, but for apportionment purposes an adjusted life is calculated as follows:

(10%/30% x 10yrs) + (25%/30% x 2yrs) + (30%/30% x 3yrs) = 8 years.

38 Relief would thus be given on 3/8ths of the gain, instead of 3/15ths under the method in the Technical Note. Our proposed calculation gives a 100% weighting to any period when the size of the pool equals or exceeds the threshold, and reduces the weighting of the other periods in proportion to the threshold figure. Other variants would be possible, but this one at least has the virtue that only the denominator of the time-apportionment fraction has to be adjusted.

39 Whilst our proposed method seems fairer than the basic time apportionment by reference to the life of the pool, it could not be described as particularly simple. It is also still somewhat distortive against the taxpayer if the eventual size of his holding is well above the threshold.

40 A simpler and possibly fairer alternative would be to take the method of time apportionment in the Technical Note as the basic rule, but (rather as in the pre-entry losses legislation) to give the taxpayer the option to calculate the qualifying part of the gain by reference to the increase in value which actually accrues during the time when the pool size is above the threshold. This method would necessitate establishing the market value of the holding on one or more dates but there would normally be arm's length transactions on those dates to provide a benchmark, and the taxpayer could still use the time-apportionment method if he preferred.

41 Additional problems arise if there is a minimum holding period. Again the principle seems reasonably clear: proportionate relief should be given depending on the proportion of the shares in the pool which have been held for the specified period. However if there have been both acquisitions and disposals within that period, one would still need identification rules in order to decide how long the shares in the pool at the time of the material disposal actually have been held. This would involve yet more legislative complexity and compliance cost. This is a further argument against having a minimum holding period.

42 Yet another issue arises where shares are acquired as part of a single transaction or linked series of transactions on different days over a relatively short period, particularly where the investor is building up a holding prior to launching a takeover bid. If the intention from the outset is to acquire control, or a 29.9% holding if this is enough to meet the substantial holding test, it would accord better with the stated policy of the relief to treat the purchases as a single acquisition made on the date of the first of them. Provided that the threshold was actually reached as a result of the series of purchases, all the shares concerned would then qualify for full relief even though some of them would actually have been acquired shortly before the threshold was reached. This approach would also greatly simplify any time apportionment calculations.

43 Acquisitions qualifying for this special treatment might be defined in subjective terms by reference to the investor's intention to acquire control, or some lesser percentage interest which is above the threshold. A simpler and, therefore, better alternative would be to treat any purchases made within, say, six months before the date when the threshold is actually reached in this way. Progressive acquisitions of this sort over a short period are most unlikely to occur without the investor having had the relevant intention from the outset.

On which shares can gains be deferred?

44 As the Technical Note concedes, the answer to this question depends on how a substantial shareholding is to be defined. However, the correct principle seems to be that the relief should be available on any form of investment which is likely to reflect the value created by the investor's exercise of his influence over the company. There is no logical necessity for this to be confined to the class(es) of shares which actually give him that influence. It should certainly include non-voting equity shares, whether

or not they are taken into account in the substantial shareholding test. It should also include convertible shares or securities.

45 There is even an argument it should include fixed-rate preference shares, since if the investor succeeds in turning round a failing company these too may increase in value as a result of his efforts. However as any gains on these will more often be due simply to changes in market interest rates rather than an increase in the underlying value of the company, it is perhaps reasonable to exclude them. (The same principle applies to non-convertible loans, but these are unlikely to be chargeable assets in any case.)

Chapter 5: The Shareholding as a Qualifying Reinvestment

What types of share should qualify?

46 We agree that the types of shares (and securities - see above) which qualify as reinvestments should be the same as those on which a gain can be deferred. The comments above under ‘On which shares can gains be deferred?’ therefore apply here too.

What size shareholdings should qualify?

47 We agree in general that only share purchases which take the company’s or group’s holding above the threshold, or which are made when the threshold has already been exceeded, should qualify. However, when the reinvestment is made into a listed company it is quite likely, contrary to the assumption in the Technical Note, that it will be built up by a series of purchases over a short period. We consider that where a series of purchases is made in pursuance of an intention to build up a holding in excess of the threshold, and the threshold is in fact exceeded, the whole series should qualify.

48 Essentially the same issue arises in relation to the holding on which the chargeable gain accrues, and this has already been discussed above. We would propose the same solution in the present context, i.e. that purchases made within the six months before the date when the threshold is actually reached should be aggregated and should therefore all qualify.

49 Whatever approach is eventually decided on, it is important that the same approach should be used in deciding whether an original holding which was built up by a series of transactions qualifies for the relief and whether a new holding which is built up in this way qualifies as a reinvestment. There may be no logical necessity to use the same test for both purposes, but it would be excessively confusing for the taxpayer if the legislation applied different criteria for aggregating a series of acquisitions in the two contexts. More generally, it would be confusing and would probably give rise to anomalies if there were different criteria for the original holding and for the reinvestment, such that a holding which qualifies as a reinvestment may not itself qualify for the relief when it comes to be sold, or *vice versa*.

Over what period of time should the shareholding continue to be a qualifying reinvestment?

50 Broadly, three years seems a reasonable period for any clawback provisions to apply.

51 We would agree that in general the relief should be clawed back if the reinvestment company ceases to meet the qualifying conditions or if the shareholding ceases to be a substantial shareholding. It may be that the disposal by the reinvestment company of the whole or a substantial part of its trade would also have to be a clawback event (except in the case of an intragroup reorganisation, as discussed below), to prevent the trading requirement being circumvented by a rapid sale of most of the reinvestment company's trade while leaving behind just a minimal trading activity to preserve its trading status. This would again raise the question of defining 'substantial'.

52 However, the gain arising as a result of a clawback should itself be capable of being deferred if a new qualifying reinvestment is made.

53 A clawback gain should also be capable of being set off against an actual capital loss arising on disposal of the reinvestment within, say, two years after the clawback event. This would be designed to provide relief where the reinvestment company fails and is wound up, but the cessation of trading crystallises the clawback some time before the winding up is completed. Without such a provision, the timing mismatch between the clawback gain and the actual loss is likely to mean that (as has happened in other contexts) an investor who has made a loss overall is still left paying tax on the clawback.

54 Some protection will probably also be needed to prevent a clawback occurring if the reinvestment company temporarily ceases to meet the qualifying conditions to a small extent and for reasons beyond the investing company's control. The need for this will depend on exactly what the qualifying conditions actually turn out to be. If, for example, there is a quantitative test involving a comparison between the value of the company's trading assets and its total assets, it would be reasonable to trigger the clawback only if this test is failed on two successive balance sheet dates. Then if the company holds an investment which suddenly increases in value, it would have a reasonable time to dispose of it and distribute any surplus cash.

55 There will also need to be some rule preventing a clawback if the reinvestment company ceases to trade as a result of an intragroup reorganisation. This issue is addressed later.

56 We do not agree that return of value should be a clawback event. We believe that in the context of this relief (in contrast for example to the EIS, which is aimed at an entirely different type of investment) there is generally no mischief in a return of value, and moreover that any attempt to penalise it would make the normal conduct of business impossible.

57 The majority of reinvestments will probably be in 100% subsidiaries, and even where the investment is smaller the underlying requirement for the relief is that there should

be substantial influence. There will, therefore, necessarily be extensive transactions between the two companies. Within a group, for example, it would be normal practice to operate a cash pooling arrangement whereby any surplus cash in the subsidiary at the end of each day would be lent to the parent or to a group treasury company. Clearly any provisions remotely similar to the return of value rules in the EIS would make such activities impossible (apart from being absurdly complicated and unacceptable for that reason alone).

58 Provisions which only applied to an actual shift of value, and, therefore, excluded loans and other transactions for full value, would be only marginally less damaging. It is impossible to conduct business between group companies on the basis that every transaction must be on strictly arm's length terms if catastrophic tax consequences are not to ensue. In any event, it is only reasonable that the investor should draw dividends from its investment and there seems to be no policy reason to prevent it.

59 Return-of-value provisions in any case achieve nothing in a group context. If the investor purchases a new subsidiary it gains the effective use of that company's cash and other assets, for most purposes, even if it leaves them strictly where they are. Management and shareholders will generally consider the group's activities on a consolidated basis, so apart from the strictly commercial considerations mentioned above there is no need to undertake any intragroup transactions on which a return of value rule could bite. Admittedly it may be necessary to take a dividend from the subsidiary in order to fund the investor's own dividends, but only dividends from post-acquisition profits can be used for that purpose and they must surely be unobjectionable.

60 There can, moreover, be no true return of the value of the investment if it takes the form of the purchase of existing shares from a third party. The value has irretrievably passed to the vendor. It is true that the investor may in a sense get its money back if the reinvestment is in a company which holds surplus cash, but the answer to this lies in ensuring that a cash shell of that sort does not qualify as a reinvestment, not in return-of-value rules.

61 We accept that different considerations apply if the investment takes the form of subscription for new shares in a subsidiary, so that the cash never leaves the group, and these are dealt with below.

What special rules are needed in the case of groups of companies?

General principles

62 In general a group should be treated as a single entity for this purpose, as it is for most capital gains purposes. Hence gains realised by one member of a group should qualify for relief by reference to a reinvestment made by another member of the group, as in the existing section 175, TCGA 1992 and the shareholdings of group companies should be aggregated for the purpose of the substantial shareholding requirement. It seems reasonable to use the existing section 170, TCGA 1992 definition of a group for this purpose.

- Intra-group share issues

63 Reinvestment by subscription within a group raises particular problems, as recognised in the Technical Note. If such investments are allowed to qualify for the relief then there is the potential, even without deliberate manipulation, for multiple relief to be claimed on what is in essence the same investment if cash:

- is invested in new shares of a subsidiary which then uses it to purchase assets within the section 155, TCGA 1992 classes, and/or
- is cascaded down through several companies in the group by a sequence of qualifying investments.

64 The idea of allowing relief for reinvestment in a group company seems in any case to be contrary to the principle of treating a group as a single entity. It would appear unreasonable to allow a group company to roll over a gain by reinvesting the proceeds in shares in a subsidiary, which uses the money for working capital, when for a stand-alone company working capital is not a qualifying class of asset.

65 We conclude that relief should not be given for reinvestment in the form of subscription for new shares of a company which is a member of the same capital gains group.

66 It is reasonable to consider whether deferral relief should be allowed even outside the capital gains tax group for reinvestments which take the form of subscription for new shares, as opposed to the purchase of existing ones. At one extreme, a 74% subsidiary may well be effectively managed as part of the group in much the same way as a 75% one, so allowing relief for reinvestment by subscription raises much the same problems in one case as in the other. However, at the other extreme, for a holding in the region of the (say) 30% threshold the management link will be much weaker and an injection of new share capital into an associated company of that sort seems just as legitimate as a way of expanding the investing company's business, as purchasing existing shares from a third party.

67 One possibility might be to allow deferral for reinvestment in new shares of a company outside the investing company's capital gains group, but only to the extent that the cash is used by the investee company to acquire assets within the classes of assets specified in section 155, TCGA 1992.

68 As in section 152 itself, one would not need actually to trace the cash: the amount of the qualifying reinvestment would simply be the lesser of the amount subscribed by the investing company for the shares and the amount expended by the investee company on section 155 assets, within the usual four-year period in each case. It would be for consideration whether the investee company should be allowed to use the same investment in section 155 assets to roll over gains of its own, or whether the companies would have to decide by joint election that the investment should be used in one way or the other. Probably some form of joint election would be necessary in any event, to prevent two or even three 30% shareholders all claiming relief for share subscriptions on the strength of the same underlying investment in tangible assets by the investee company.

Group reorganisations

69 The Technical Note accurately identifies the commercial need for a relief from clawback in the case where a reinvestment company ceases to trade as a result of an intragroup reorganisation, and also the difficulties which are involved in formulating such a relief.

70 The only practical approach seems to be that the deferral relief should follow the trade, so that a disposal of the transferee company's shares would crystallise the gain. It would be very complicated to extend this arrangement to cover all the possible types of reorganisation, including division of trades between two or more companies, and successive transfers. However, one case which ought to be covered if at all possible is where the newly acquired company's trade involves two or more distinct areas of activity and it is desired to merge these with the corresponding activities which are already being carried on by the acquiring group but in different companies.

71 It should be possible, without complicating the rules unduly, to allow reorganisation treatment if, but only if, either

(i) the whole of the reinvestment company's trade is transferred in a single transaction to a single transferee; or
(ii) separate parts of the trade, together amounting to the whole of it, are transferred simultaneously to two or more transferees.

In the latter case the deferral relief would follow the separate parts of the trade, either on the basis of a just and reasonable apportionment or in a specified proportion, e.g. in proportion to the value of the assets transferred to each company.

72 Similarly it would be too complicated to extend this treatment to all subsequent intragroup reorganisations involving a transfer of the reinvestment company's original trade, or parts of it, if only because the original trade would rapidly cease to be identifiable once it was merged with that of another company after the first reorganisation.

73 On the other hand there seems to be no reason not to allow relief for successive reorganisations in the limited circumstances where the company (A) which was the transferee in the first reorganisation later transfers the whole of its trade to a second transferee (B). The deferral relief could then simply be transferred to the shares of B. There would be no need to try to analyse the trade transferred at that stage between the original trade of A, the activities acquired by A from the reinvestment company in the first reorganisation, and any new activities commenced by A subsequently.

Value shifting

74 Paragraph 5.15 of the Technical Note suggests that special clawback provisions may be needed to deal with value shifting within groups.

75 The potential problems arising from a transfer of the reinvestment company's *trade* or part of it, if this is not treated as a clawback event in itself, are reasonably clear and

are dealt with above. We are not able to see what additional mischief is thought to be achievable by transfers of *value*, whether effected by a transfer of the trade at undervalue or otherwise.

76 An attempt might be made to shift value out of the reinvestment company before reselling it, so as to generate an allowable loss which could be set against the clawback gain, but the existing anti-avoidance provisions should be sufficient to deal with this situation. On the other hand if the idea was to retain the reinvestment company indefinitely but to shift its value into another group company which could then be sold, this seems to achieve nothing because the value shift will inflate the chargeable gain which arises on sale of the second company.

77 If the concern in this area could be more clearly identified we would be pleased to comment further.

Chapter 6: How should the new relief work?

The interaction of the new deferral relief with the existing business assets rollover relief

78 We agree that the new relief should be integrated with the existing business assets relief.

The time limit for reinvestment

79 We agree that the time limits should be the same as for the existing business assets relief. The same system of provisional relief under self-assessment should also apply.

Reinvestment of disposal proceeds

80 We agree that relief should be given by reference to the application of proceeds.

Mechanism for achieving deferral

81 Rollover is generally easier to administer than holdover, particularly where share pools are involved. However, it seems doubtful whether there is any practical way of operating a share pool if clawback can be triggered by events other than disposals of shares. How, for example would one deal with a part disposal of the share pool (containing some shares which represented qualifying reinvestments and some which did not), followed by a clawback event?

82 We would suggest a hybrid system, in which shares which are qualifying reinvestments are kept outside the pool for the duration of the (say) three year potential clawback period, the relief effectively operating as a holdover for that period, but rollover applies thereafter.

Chapter 7: Provisions to safeguard the relief against exploitation

Value returned and value shifting

83 We have discussed above the extent to which we can see a need for anti-avoidance provisions to counter the sort of avoidance described in paragraph 7.3 and 7.5 of the Technical Note. We would only repeat here that while we can certainly see some possible forms of manipulation which would have to be prevented we believe that the concerns expressed specifically about return of value and value shifting are rather off the point.

Share exchange involving qualifying reinvestment

84 If the deferral relief operates as a rollover section 135, TCGA 1992 will automatically transfer the reduction in base cost to the new holding on a reorganisation, and no additional legislation is needed.

85 However, as discussed above we think it is inevitable, if there are to be clawback events other than the disposal of the reinvestment shares, that those shares will have to be kept at least for a time outside the pool and there will have to be identification rules to deal with part disposals. It should then be possible to deal with share exchanges without too much additional complexity, by providing that in these circumstances section 135 operates in a modified way, such that the shares issued in exchange for the reinvestment shares also remain outside the pool and inherit the potential clawback. Under the hybrid arrangement proposed above this system would only need to operate for the duration of the clawback period.

Connected company acquisitions and disposals

86 We accept that transactions with connected persons should not be qualifying disposals or qualifying reinvestments. Allowing transactions within a capital gains group to qualify would be inconsistent with the principle of treating the group as a single entity, and even outside the 75% group the provisions which would no doubt be included in order to prevent manipulation by connected parties are likely to be so complicated and so extensive that it would be better simply to exclude such transactions altogether.

Wider ranging protection

87 We are strenuously opposed to any form of general anti-avoidance rule, not least on the grounds that avoidance is a subjective matter. Views of what is avoidance can and do vary from person to person, and even in the mind of one person (or Government department) from time to time.

88 However, we do not object to a form of anti-avoidance measure which is expressed in terms of the mischief to be countered, rather than trying to enumerate exhaustively the types of transaction in which that mischief may be present, provided the mischief is specifically identified rather than just being expressed as ‘avoidance of tax’. Indeed this sort of semi-purposive drafting may in appropriate cases create less uncertainty than the traditional style, and it certainly makes it easier for the reader to understand

what it is trying to cover. Having said that, this type of provision does require the draftsman himself to be very clear about his target. It should not be used as an excuse for woolly drafting. In particular the proposition put forward in the Technical Note would need a good deal of further refinement to define when value is considered to be realised from a shareholding, before it could be accepted as being sufficiently certain in its effects.

OTHER POINTS

89 We believe consideration should be given to extending the proposed new relief to gains that arise under section 179, TCGA 1992. The deferral relief is proposed according to paragraph 1.8 of the Note to help prevent companies being locked in to their investments and to allow them the flexibility of making a strategic move from one investment area to another. The realisation of a taxable gain in these circumstances is regarded as inhibiting market based decisions.

90 In the detailed proposals it is envisaged that a gain qualifying for deferral relief may arise at various levels within a group, thus giving a group considerable flexibility as to precisely how it makes any relevant disposal. The existing asset rollover/hold over reliefs also contribute to this flexibility. Therefore, once the new relief is in place, and all relevant conditions fulfilled, a group may make a disposal of a trade in any number of ways and qualify for deferral relief. Those ways could be:

- a disposal of the actual assets of the trade (including goodwill);
- a disposal of the shares of the company carrying on the trade; or
- a disposal of the shares of an intermediate holding company.

91 However, these situations do not cover all the ways in which a group might realise a gain on divesting itself of a non-strategic business. It might be that a business being disposed of has been assembled within one subsidiary by transfers of trades and assets from various group subsidiaries and that a sale or flotation of that company is the best commercial route to follow to make a strategic exit from the business in question. Alternatively, it might be that a sub-group has been put together housing a number of non-core subsidiaries under a new holding company and that company is to be sold.

92 In both the circumstances described in paragraph 91 above, the actual gain arising may be small or non-existent but the section 179, TCGA 1992 gain within the companies being sold is very material. It may be entirely an accident of history as to whether a disposal results in a material actual gain to the disposing company or a material section 179, TCGA 1992 gain within the company sold.

93 The existence of such an in-built gain may inhibit the disposal as the disposing company. It is very likely to have to pick up the cost, either by an immediate cash contribution or by operation of an indemnity. There is therefore a very strong case for inclusion of section 179, TCGA 1992 gains within the new deferral relief where an actual gain on the shares disposed of would qualify.

94 There are some issues to deal with, mainly due to the fact that section 179, TCGA 1992 gains arise in the company disposed of and not the disposing company. This could be dealt with by permitting disposing companies to elect to have a section 179, TCGA 1992 gain accrue to them in place of the company leaving the group. A secondary liability could remain with the latter to protect the Inland Revenue's position.

CONCLUSIONS

95 We welcome the proposed relief. However, it is important to remember that the new relief will not be as generous as comparable reliefs in most other developed countries including, for example, the participation exemption in the Netherlands. Whilst this proposed relief is likely to encourage UK companies to invest directly and not through sub-holding companies located offshore, it is unlikely to encourage foreign investors to use the UK as an investment base.

96 The rules defining the new relief must be simple and certain. They must not involve excessive clawback provisions because otherwise the relief will not be attractive, either to UK based companies or foreign investors.

97 It is essential that the new relief and legislation do not follow the inordinately complex and restrictive pattern established by the EIS.

98 The consultation period of seven weeks is too short. It should have been a minimum of two months and preferably three. We trust that if we have any further comments after the deadline of 11 August, you will be happy to consider them.

99 Our key recommendations concerning the relief are:

- We see no reason why close companies should be excluded from the relief;
- The minimum shareholding required to qualify for the relief (both on the sale and reinvestment) should be 20%;
- There should be no minimum holding period;
- The list of securities qualifying for the relief should include non-voting shares and convertible shares;
- The three year clawback period is reasonable but there should be a relief to allow a subsequent loss to be offset against any gain on clawback.
- The new relief should be linked to the existing business asset relief.
- Consideration should be given (subject to suitable safeguards) to extending the relief to include gains arising under section 179, TCGA 1992.

100 If you have any questions, please let us know. We are happy to discuss any of the issues raised in this representation further with you if that will be of assistance. We would also welcome feedback on the consultation process and the reasoning behind the take-up or rejection of the proposals raised.

FJH
14-46-16

10 August 2000