

## **TAXREP 38/01**

# **AN EXEMPTION FOR SUBSTANTIAL SHAREHOLDINGS**

*Text of a memorandum submitted in December 2001 by the Tax Faculty to the  
Inland Revenue setting out key points in response to a Technical Note issued by  
the Inland Revenue on 27 November 2001*

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## **AN EXEMPTION FOR SUBSTANTIAL SHAREHOLDINGS**

### **INTRODUCTION**

- 1 We welcome the opportunity to comment on the issues raised in the Inland Revenue Technical Note on 27 November 2001.
- 2 We responded to the previous consultation document 'Large Business Taxation' in September 2001, which was published as TAXREP 21-01.
- 3 We have also been involved with the ongoing working party which has been looking at this proposal. Once again, we have found this very useful and congratulate the Revenue on this open and positive approach to consultation. We are pleased that this latest Technical Note includes draft legislation and commentary.
- 4 We welcome the proposals and the draft legislation set out in the Note. Our initial review of the proposals identified a shortlist of key points which we would like to make. Rather than wait until the consultation deadline of 31 January 2002 before making our submission, we have set these out below. They cover the following points:
  - roll-over of degrouping charge on business assets;
  - what is a substantial shareholding;
  - definition of 'qualifying trading company';
  - uncertainty with the definition of substantial and intra-group activities; and
  - interest disallowance.
- 5 We trust that an early submission of the key points is helpful. If, following a more detailed review, we have further comments to make we will ensure that they are made by the 31 January 2002 deadline.

### **KEY POINTS**

#### *Roll-over of degrouping charge on business assets*

- 6 We welcome the new provisions which allow for rollover of a degrouping charge under section 179, TCGA 1992, and for reallocation of a degrouping charge to other companies in the old group. However we find the drafting style in these provisions particularly unhelpful. The technique of notionally amending an existing section as it applies for a particular purpose makes it impossible for the reader to understand what has been done unless he has both the old and the new legislation in front of him. Further, we doubt that the commercial publishers will print the legislation in its amended form where the amendment only applies for a particular purpose. Ideally,

what is required is that the new legislation sets out in full the substituted versions of the sections which are being amended. However, as most of the amendments relate to sections 152, 153, 159 and 175, providing substituted versions of these sections would go a long way to solving the problem.

- 7 We also find the interaction of the two changes rather confusing. It is clear from paragraph 7 of the draft schedule 1 that it is intended that a degrouping charge can be rolled over under section 175, TCGA 1992 against new assets acquired elsewhere in the group. But is it possible alternatively to reallocate the degrouping charge under the new section 179B to company C, and for company C then to roll over the gain against acquisitions of its own under section 152? The draft legislation on intellectual property does explicitly contemplate the possibility of a reallocated gain being rolled over in equivalent circumstances, but paragraph I13 of that legislation includes some detailed deeming provisions which we would have thought would also be needed in the chargeable gains legislation.
- 8 There does not actually seem to be much need to have two alternative methods for intragroup rollover of a degrouping charge, but one does at least need to be clear in each case about what is possible and what is not. More generally, it is highly desirable in the interests of simplicity that the rules on the degrouping charges for intangible assets and for chargeable gains should be the same. We appreciate that some differences in the drafting of the two sets of provisions are inevitable, so long as one is drafted in 'rewrite' style and the other is not, but we had expected that they would in substance be closely parallel to one another, which at present they seem not to be.

*What is a substantial shareholding (paragraph B 11)*

- 9 In principle, as we stated in our earlier representation, we think this threshold is reasonable and we understand the policy concern not to extend the relief to portfolio investors. However, we remain concerned that relief should be available for joint venture type arrangements where the shareholding may be less than the 20% figure but the holding is nevertheless a 'structural' holding. It was for this reason that we suggested a threshold of 10% rather than 20% in our earlier representation, which we thought struck a reasonable balance and could be justified by reference to, say, the threshold for underlying tax relief in most UK double tax treaties.
- 10 We remain concerned that the 20% threshold does not cater adequately for such arrangements and we think the Government should reconsider the question of allowing relief for a 10% shareholding where it is clearly a structural holding. We appreciate of course the difficulties in framing a suitable test which allows relief in such circumstances but which excludes portfolio investors. One suggestion which has been put to us which we found attractive is to allow relief for a holding which is 10% or more but less than 20%, subject to the further test that the shareholder has the power to appoint a director. This test would establish a necessary structural link between the companies over and above what would be expected if the investor was merely a portfolio investor.
- 11 We recognise that such an idea (or some variant of it) must have been mentioned by other respondents as it is referred to at the end of paragraph B11 and so we assume

that it has been rejected. However, we urge the Government to reconsider this idea and we would be happy to explore further how this idea might work. It would be necessary for the power to be a real one which is exercised for bona fide commercial reasons and not for tax avoidance purposes.

*Definition of 'qualifying trading company'*

- 12 We are disappointed that the definition of a qualifying trading company excludes certain activities set out in paragraph 19 of the draft schedule 2 unless they are the 'trading activities of a finance company'. These 'excluded activities' (although the draft legislation does not use that term) include the holding of intellectual property and leasing any description of property or rights.
- 13 We think that these categories are too restrictive and exclude certain activities which we believe the Government is seeking to encourage, namely the development and exploitation of intellectual property. A suitable precedent would appear to be the similar test for the purposes of the Enterprise Investment Scheme. This definition was changed in FA 2000 (see paragraph 13 of Schedule 17 to the Finance Act 2000) so that relief is available where the trade consists to a substantial extent in the receiving of royalties or licence fees from the exploitation of 'relevant intangible assets'.
- 14 We think that the activities set out in paragraph 19 should be amended to include an exception for income received from the exploitation of relevant intangible assets defined in the same way as for EIS.
- 15 More than that, however, we are concerned that even an ordinary manufacturing company which depends on using a patented process could well be said to be holding intellectual property as a substantial part of its trading activities, regardless of whether the patent has been developed internally or acquired from someone else. The company's trading income would be entirely dependent on holding the patent, and the argument that merely holding intellectual property is a passive function which cannot in itself be part of any trading activities is not available, since paragraph 19 of the draft legislation clearly assumes the contrary. The best solution to this would probably be to remove the reference to holding intellectual property from paragraph 19 altogether: it appears that it is licensing (which would be covered by 'leasing any description of property or rights') rather than the mere holding of such property which is really the intended target.

*Uncertainty with the definition of substantial and intra-group activities*

- 16 We said in TAXREP 21/01 that the requirement that the investing company must be a trading company or member of a trading group is too restrictive, and we remain of that view. We note the Government's wish to ensure that the relief cannot be used by an individual to avoid tax on gains arising on what are in substance personally held investments, but this could be prevented, as we suggested previously, by excluding investment companies which are close companies.
- 17 We are particularly concerned that merely holding the shares of one significant associated company, being an activity which is not a trading activity, is likely to disqualify a group from the relief in respect of any other substantial shareholdings, or

indeed in respect of the disposal of the associated company itself. The rules on joint venture companies in paragraphs 22 and 23 of the draft schedule 2 go some way towards dealing with this problem, but are too narrowly drawn. In particular many associated companies, even if they are true joint ventures, will not satisfy the requirement for a 30% minimum holding.

- 18 As a minimum, since the 20% threshold for a substantial shareholding was selected with a view to covering most joint ventures, the same threshold should apply in paragraph 23.
- 19 Subject to these points we welcome the adoption of the test based on activities or intended activities rather than purposes, for both a company and a group, and the new subsidiary exemption where the main conditions have been met within the previous two years. However the way in which the activities test is to be applied is not defined in any detail in the draft legislation.
- 20 We understand that, despite the distinction between activities and purposes, the intention is that the test should be similar in its effect to that which applies for CGT taper relief. The Revenue should therefore confirm publicly that the interpretations for taper relief set out in Issue No.53 of Tax Bulletin will apply, *mutatis mutandis*, to the new relief as well. Points which we would particularly like to see confirmed are that 'substantial' will be interpreted as meaning 'more than 20%', and that in considering the activities of a group as a whole intragroup activities (including the holding of the shares in a subsidiary by its parent) will be ignored.

#### *Interest disallowance*

- 21 In our earlier representation, we requested that an amendment should be made to paragraph 13 of Schedule 9 to FA 1996 to put beyond doubt that this will not restrict interest relief in respect of substantial shareholdings gains from which are exempt. This point does not appear to have been addressed and we are disappointed not to have received any response to our request. Our members have continued to express concern that the Revenue could restrict interest relief under this existing provision without the need for further legislation. We think that an amendment is required or, failing that, a formal statement that the existing rules will not be applied in this way.

### **CONCLUSIONS**

- 22 We welcome the ability to roll-over a degrouping charge but the legislation needs to be redrafted so that it is more user friendly.
- 23 In respect of the substantial shareholding threshold, we think that relief should be available where the investing company owns more than 10% and has a right to appoint (and does) a director for bona fide commercial reasons.
- 24 The definition of a qualifying trading company should be extended to include the exploitation of relevant intangible assets in a manner similar to the amendments made to the EIS rules in the FA 2000.

- 25 We are concerned that the rules on qualifying activities of joint ventures companies are too narrowly drawn. The 30% threshold should be reduced to 20%.
- 26 To avoid uncertainty, the Revenue should confirm that its interpretation of the taper relief rules set out in Issue 53 of the Tax Bulletin should apply also the purposes of this relief.
- 27 To avoid uncertainty, the Revenue should specifically confirm that interest relief will not be restricted under the loan relationships rules.
- 28 If you have any questions, please let us know.

FJH  
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