THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Taxation

Tax Representation

TAXREP 5/04

CORPORATION TAX REFORM: THE NEXT STEPS

Text of a memorandum submitted in February 2004 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Inland Revenue in response to the Technical Note published in December 2003

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INTRODUCTION

1. We welcome the opportunity to respond to the Technical Note issued by the Inland Revenue in December 2003. This follows on from the Consultation Document issued by the Inland Revenue in August 2003. Our response to that earlier Consultation was published in November 2003 as TAXREP 40/03.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).

4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter ‘TAXline’ to more than 11,000 members of the ICAEW who pay an additional subscription.

GENERAL COMMENTS

Transfer pricing

5. In general we welcome the constructive approach that has been shown in limiting the practical difficulties that will arise with the extension of the transfer pricing regime to UK to UK transactions.

6. Paragraph 4.30 suggests that because of the degree of judgement involved in establishing appropriate ‘arms-length’ results it would often be sensible for a business to have a discussion with its tax office about transfer pricing issues before a tax return is made, or even before the transactions take place.

7. We believe that this will be an extremely valuable way to try and achieve some certainty about the transfer pricing provisions as they apply to particular situations. We believe that it would be advantageous to go further and introduce a statutory procedure for an agreement between the taxpayer and the Revenue which would be binding on the Revenue.

8. We also believe consideration should be given to introducing a *de minimis* threshold below which transfer pricing adjustments will not be required to be made. The CFC regime does not apply if annual profits are below £50,000 and we believe some equivalent threshold should be introduced for the transfer pricing regime.

Thin capitalisation

9. It is evident that subsuming the thin capitalisation regime within the transfer pricing rules, which are extended to UK to UK transactions, is going to cause considerable compliance costs to UK groups, particularly those with a large number of dormant subsidiaries. There are many commercial reasons why companies that are dormant are retained within a group, for instance the protection of intellectual property rights in the company name and the significant costs of liquidation.

10. We recommend that there should be some form of exemption from the provisions in respect of companies that have been dormant for a reasonably lengthy period, and recommend that three years would be a reasonable period to adopt.

11. We also believe there will be problems if the guarantor of a thinly capitalised UK company is non UK resident and does not trade in the UK via a Permanent Establishment. The election to give the deduction to the guarantor is of no benefit if the guarantor is not subject to UK tax. This would appear to be discriminatory and therefore contrary to European law if the guarantor is based in the EU.

12. Moreover if the guarantor in such cases is treated as if it had paid the interest it is not clear how withholding tax provisions are to be applied. We would welcome clarification on this issue.

Matching indirectly held assets

13. For exchange movements on foreign currency liabilities and derivatives to be matched for tax purposes with non-monetary assets, such as shares in an overseas subsidiary, the exchange movements must arise in the company that holds the matched asset, and must be taken to reserves in the entity accounts of that company. However, the external foreign currency liability that is the hedge against the group's overseas investments will often be in a different company to that which is the direct owner of the relevant assets. In such cases matching can only be achieved through corresponding intra-group loans or currency derivatives. Such loans may be made to companies with small levels of equity, are often made interest free and may involve a foreign currency loan to the intermediate holding company and a sterling loan of an equivalent amount back. From the outset of the matching under the original FA 1993 rules, the Revenue has accepted that such loans are necessary for matching purposes and could be made interest free without challenge.

14. Unfortunately, the proposed amendments to Schedule 28AA, ICTA 1988 create a significant risk that such arrangements may no longer achieve the tax neutrality that they intended to give. It is not because the matching itself is rendered ineffective, but because exchange movements on the intra-group loan or derivative may be wholly or partly ignored, leaving part of the external borrowing effectively exposed to tax.

15. We are aware that the Revenue do not believe there is a problem as identified in paragraph 14 above. We should be grateful for a detailed analysis, from the Revenue, as to how they substantiate this view. Our understanding of their position is set out immediately below but, as mentioned, we would welcome confirmation that this is their position.

16. The Revenue analysis appears to be that sections 84A(2) –(10), which modify section 4(1) FA 1996, take precedence over any paragraph 11A Schedule 28AA ICTA 1988 adjustment, so the new thin capitalisation provisions don't disturb the forex rules with respect to the gross principal for FA 1996 purposes (but only the interest deductions) hence the FA 1996 matching continues to be available.

The impact of the transfer pricing and thin capitalisation proposals for charities and other bodies exempt, or partially exempt, from tax

17. There is a concern that the implications of the general extension to intra-UK transactions of the thin capitalisation and transfer pricing rules have not been fully considered in relation to companies (which are defined for corporation tax purposes to include unincorporated associations) that are wholly or partially relieved from liability to corporation tax.

18. We believe there is a strong case for exempting charities from the transfer pricing proposals. The concepts involved in arm's length pricing cannot be equitably applied to the charity sector and there is no useful OECD guidance in this area. Moreover, it is difficult to see that companies controlled by charities have any incentive to use transfer pricing to gain a tax advantage when they can eliminate their taxable profits by donating them to the parent charity.

19. As regards the thin capitalisation changes, charities currently benefit from a specific exemption in section 212 (4) ICTA 1988 from the thin capitalisation provision in section 209 (2)(d)(a) ICTA. This relief was introduced in 1995 to protect charities from an unintended consequence of the changes to the thin capitalisation rules enacted in Finance Act 1995. The draft legislation published on 10 December 2003 provides for section 209 (2) (d)(a) ICTA to cease to have effect, thus nullifying the charity exemption.

20. The proposed changes to the transfer pricing regime, including the incorporation of new rules to replace the thin capitalisation provisions, do not include any specific reliefs for charities. While it can be reasonably expected that the proposed exemption of small and medium-sized enterprises (SMEs) will effectively relieve most charities from the burden of compliance with these rules, this will be of no assistance to larger charities which cannot pass the SME tests. It is likely, for example, that many charities in the education and social housing sectors will not qualify for this exemption.

21. Charities that are subject to the new transfer pricing regime will face a number of problems inherent in the way in which they conduct their activities:

- charity trading subsidiaries are commonly established without a significant amount of equity share capital and are therefore at risk of being thinly

capitalised even if they are paying an arm's length rate of interest on a loan from their parent charity;
- charities frequently establish charity subsidiaries with which they conduct transactions that are not on arm's length terms for genuinely charitable reasons;
- charities often share the costs of staff, premises and other overheads with other companies in the group on an informal basis whereby the parent charity typically recharges these items at cost so that no element of profit arises in the parent charity due to a concern that any profit on such a management charge would constitute Case VI income outside the scope of the current statutory exemptions available to charities.

22. In these circumstances the concerns of charities are likely to be twofold. First, that where the legislation requires an adjustment to be made, the provisions to eliminate double counting in paragraph 6, Schedule 28AA ICTA 1988 will not produce effective relief where one of the parties is exempt from tax. Second, even where there is no question of any adjustment to be made, charities will still be expected to comply with the documentation requirements and, if required to complete a CTSA return will be obliged to prepare it on arm's length principles.

23. Although the comments in this sub-section focus on the position of charities, it should be noted that there are likely to be other bodies that are wholly or partially relieved from liability to corporation tax that could face similar problems for similar reasons. A good example is the social housing sector, where a single group may comprise a mix of charitable and non-charitable companies and industrial and provident societies, the assets of which are financed by external debt secured by a series of intra-group guarantees and other cross-collateral obligations. Local authorities, which are increasingly setting up subsidiaries to bid for contracts that are required to be subject to open competition, may also have cause for concern.

Securitisations

24. It was made clear by industry representatives at the special meeting with the Inland Revenue on 21 January 2004 that a high level of certainty in relation to the taxation position of securitisation structures is an absolute necessity for rating agencies which are involved in such transactions.

25. The concern is most likely to occur in Whole Business Securitisations (WBS). See the Appendix for a common WBS structure. While there are currently no more than 20 to 30 WBS transactions each year they are gaining in popularity and it is important that the taxation consequences of such arrangements are certain, particularly as far as the rating agencies are concerned. We believe that if guidance can be given in accordance with COP10 this would provide the certainty required but it would be necessary for there to be sufficient Revenue officials familiar with the complex nature of these arrangements to give the guidance sought.

26. We note that COP10 only authorises Revenue guidance in relation to proposed transactions when the relevant legislation has been passed in the last four Finance

Acts or in respect of 'other areas concerning matters of major public interest in an industry or in the financial sector'.

27. In order to place continuing reliance on the COP10 guidance procedure i.e. after four years has elapsed we would ask for confirmation from the Revenue that they do consider that the securitisation issues do constitute 'matters of major public interest in an industry or in the financial sector'.

28. Also at the meeting of 21 January 2004 a common WBS structure was discussed and the diagram was attached to the Revenue Minutes of the meeting distributed on 2 February 2004. In relation to the structure envisaged, which is reproduced as Appendix 1 to the present document, the Revenue confirmed at the meeting that to the extent that the Holding Company has no other assets other than the shares in Originator, they would probably not seek to argue that there is a thin capitalisation adjustment in Originator since the borrowing by Originator is being supported by Originator's underlying assets.

29. However, where the Holding Company has other assets, the Revenue said they might consider a thin capitalisation adjustment since the guarantee by the Holding Company may allow the Special Purpose Vehicle (SPV) to issue more debt than would otherwise be the case. In this event, any such adjustment would arise in Originator.

30. At the meeting referred to above the Revenue indicated that they would consider whether the views expressed above in relation to this common WBS structure should be included in legislation or incorporated into published guidance. We are of the view that this point should be clarified through amendment of the legislation in order to provide the requisite level of certainty.This could then be 'backed up' by published Guidance.

31. As a separate matter we strongly believe that it is appropriate to allow 'grandfathering' of existing structures.

32. The Revenue are concerned that this may give rise to avoidance e.g. 'asset thinning' in the security group. We believe that there is in practice very little risk as the majority of securitisation transactions, once established, run on pre-determined lines for their life and it is generally not possible to undertake the types of steps the Revenue indicate they are concerned about.

33. We believe that the solution would be to allow grandfathering so the current rules apply to existing structures but the new rules will be applied if there is any significant change to the existing structure after the start date of the new legislation.

34. In the absence of grandfathering arrangements advisers will be required to examine all existing structure by reference to the new rules which will impose an enormous administrative burden on business.

35. As much of the thrust of the proposals in the 'Next Steps' consultation paper is to eliminate unnecessary burdens from the introduction of the new transfer pricing and thin capitalisation rules we believe that grandfathering deserves very serious consideration by the Revenue.

36. On a point of detail in the Revenue Minutes of the 21 January meeting at paragraph 4.2.3 the Revenue indicate in their view sections 7B/6B could cover swap payments as well as interest. We understand this to refer to what are in fact new paragraphs 6B and 7B of Schedule 28AA ICTA 1988. It is not immediately apparent that swap fees are 'consideration given…..for the use of money' under new paragraph 1A(9) and so come within these provisions. We should be grateful for clarification of the Revenue analysis of the position.

Extension of relief for expenses of managing investments

37. Along with many commentators we have welcomed the proposal, repeated in the present Technical Note, to extend corporation tax relief for the expenses of managing investments by lifting the requirement to qualify as an investment company.

38. However we have serious reservations about the additional proposal, not included in earlier discussion documents, 'to exclude capital expenditure from deduction as a management expense.' We are concerned that the proposal will introduce major uncertainty, and quite possibly a substantial change in the law which may or may not be intended.

39. The proposal would appear to be a direct reaction to the decisions by both the Special Commissioners and the High Court in the case of *Camas plc v Atkinson,* rejecting the Revenue argument that expenses of a capital nature can never qualify for relief as expenses of management.

40. For reasons which we enumerate below this would undermine the long held distinction under which for investment companies the costs of *managing* investments are allowable but not those of *acquiring* investments. The former are deductible under section 75 ICTA 1988 while the latter are not. Case law, and in particular the House of Lords decision in *Sun Life Assurance Society v Davidson* [1957] 37 TC 330, has for more than 40 years determined that the costs incurred to help a company to decide to invest are costs of managing investments (and so deductible) while costs incurred after the decision to buy has been made are costs of acquiring the investments (and so disallowed). This has long been the established legal position.

41. The *Camas* case should resolve one point of law which has not hitherto been clarified. This is the correct treatment of abortive acquisition costs. The High Court overturned the decision of the Special Commissioners and ruled that the abortive acquisition costs were costs of managing investments, and so they were deductible. We understand the appeal in this case is to be heard by the Court of Appeal in April this year.

42. The current proposal would therefore pre-empt the decision of the Court of Appeal, and potentially the House of Lords in this matter. The explanatory notes seem also to be trying to imply that the change would merely be reinstating what has been the generally accepted view of the law, and we would strongly dispute that. We think it is wrong for the Revenue to proceed in this way. If the *Camas* decision is reversed on appeal this part of the proposed legislation is unnecessary; if not, it represents a substantive change in the law which (if pursued at all) should be put before Parliament as such.

43. We are also concerned that the proposal will go even further than this and will in effect prevent a deduction even for expenditure incurred prior to making a positive investment decision, since at least some such expenditure may be argued, by analogy with the precedents relating to trades, to be capital in nature. We believe the effect of the proposal, compared with the present situation, may well be as shown in the Table below:

Expenditure	*Current case law position*	*Post FA 2004 position*
Prior to investment decision	deductible	Non deductible?
Post investment decision	Non deductible	Non deductible
Abortive costs	Deductible (subject to appeal)	Non deductible

44. This would entirely reverse the currently accepted position as established in the *Sun Life* case. We would argue that the analogy with Case I principles is false, since investments are not analogous to the fixed assets used in a trade but rather are a separate asset category intermediate between fixed assets and trading stock, but the outcome of any such argument is uncertain.

45. The Technical Note indicates that the purpose behind the change is 'to ensure that relief for the expenses of managing investments is aligned with relief for trading expenditure.' However in our view the activities of trading and investment are so different that there is no meaningful way in which the tax reliefs given to each can be 'aligned'`. Even if the same form of words is used for each, for example to disallow capital expenditure, the effect will be different for each type of business.

46. Indeed there is, so far as we are aware, not even any judicial precedent on what would count as capital expenditure in the context of an investment business. The usual question in relation to investment activities is what expenses should properly be *charged against* capital, but that does not depend on the capital or income nature of the expense itself. At the least, therefore, the proposal will introduce major uncertainty. This is because it will take many years for the Courts to determine the relevance to investment companies of all the case law on the income/capital divide which has been developed in the context of trading companies.

47. If the Government is determined to press ahead with this proposal then it is incumbent on them to give a clear indication of the effect they believe the change will have in practice, particularly on the treatment of acquisition-related costs, including abortive costs. It would be wholly wrong for the Government to seek to attempt to move the cut off point between allowable and disallowable expenditure, which was established more than 40 years ago in the House of

Lords, without making it abundantly clear to taxpayers and to Parliament that that is what they are proposing to do.

Extension of relief for expenses of managing investments – drafting points

48. We also have a number of drafting points in relation to the related draft clauses on management expenses in Chapter 3 of the Technical Note.

49. New section 75A(3) on management expenses sets off any non-taxable income (subject to the two stated exceptions) against the expenses qualifying for relief. This is not confined to non-taxable income arising from the investment side of the company's business. Hence if a group does have non-taxable income - mutual trading is the example which comes to mind - it will still be to its advantage to keep the investment business in a separate company. This is contrary to the objective of the new legislation, which is supposed to remove the need for group structuring to be driven by tax considerations of that sort.

50. Similarly, in new section 75A(4), the excess management expenses available to carry forward are defined to include "any charges on income paid in the accounting period wholly and exclusively for the purposes of the company's business", rather than being limited to those which relate to the company's investment activities. It would seem therefore that excess trade charges will be carried forward as management expenses in any company which has some investment activity. This seems anomalous.

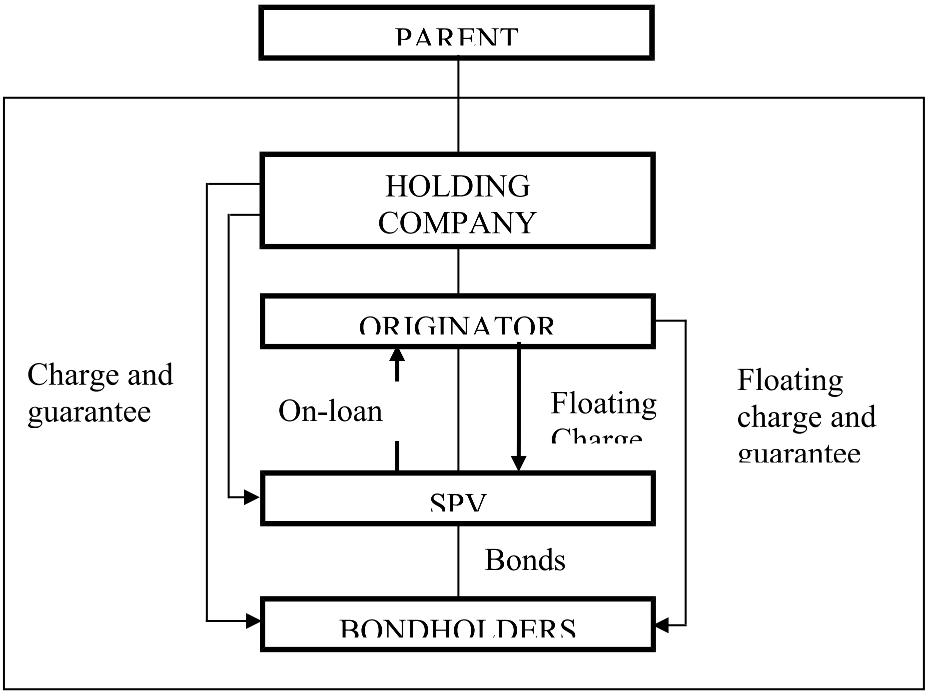
51. Under section 75 (5) there is no relief for management expenses unless the company is within the charge to Corporation Tax. At the management expenses meeting between representatives and the Revenue on 14 January 2004 the concern was expressed that this would prevent a UK company getting relief for management expenses incurred managing an overseas company which is held indirectly. The suggestion that the Revenue made at that meeting was that any such activity could be viewed as management of the intermediate direct subsidiary, which would be an activity within the charge to Corporation Tax, and, indeed, could not qualify for management expenses relief on any other basis.

52. It would be helpful to have confirmation that this is the correct interpretation.

53. There is also a wider point. This is whether section 75(5)(b) would preclude relief for management of equity investments in UK companies, which can only generate income in the form of Franked Investment Income and on which capital gains may be exempt under the Substantial Shareholding Exemption. Paragraph 3.23 of the explanatory notes says not, and the Revenue have previously given assurances on the corresponding question in the loan relationships legislation. Nevertheless it is a point of real doubt, which we would much prefer to be covered by the legislation than by Revenue pronouncements of doubtful legal effectiveness.

54. Under current legislation appeals in respect of management expenses can only be heard before the Special Commissioners. The proposed new legislation in draft section 75A (7) and (8) contains a similar provision. We believe that such a provision is no longer appropriate and appeals should be capable of being made to either the General or the Special Commissioners.

IKY
10 February 2004



Appendix 1
Diagram of common WBS securitisation structure
Paragraph 25 of the TAXREP above refers