Faculty of Taxation

Tax Repentation

# TAXREP 40/03

# REFORM OF CORPORATION TAX

***Text of a memorandum submitted in November 2003 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Consultation Document published in August 2003***

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Appendix 1 Answers to specific questions in the Consultation Document

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# Reform of Corporation Tax

## INTRODUCTION

1. We welcome the opportunity to comment on the Consultation Document and accompanying Background Notes issued by HM Treasury and the Inland Revenue in August 2003. We responded to the earlier Consultation Document published in August 2002 and our response was published as TAXREP 27/02. In our response to this latest Document we have set out our general comments in paragraphs 5-45 below. We have also answered the specific questions in the Consultation Document in Appendix 1.

## WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 123,000 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 Institute who pay an additional subscription.

## General comments

*Competitiveness and Fairness - Features of a competitive tax system*

*The overall criteria by which the tax system should be judged*

5. The two key objectives of the Government’s proposed reforms are competitiveness and fairness. Paragraph 1.9 of the Consultation Document sets out what the Government believes should be the main features of a competitive tax system.

6. We believe that in designing a good tax system the Tax Faculty's ‘Ten Tenets towards a Better Tax System’ set out the overarching principles by which a tax system should be judged. These are set out again in Appendix 2.

7. The Ten Tenets which relate directly to comments in paragraph 1.9 are:

   **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

   **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

   **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

   **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

   **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

8. Taken as a whole the principles set out in paragraph 1.9 are similar to those set out above.

9. However, the Ten Tenets go beyond the principles set out in the Consultation Document. It is important that not only are the reforms properly targeted but they must also be regularly reviewed.

*Some additional concerns*

*The International Context*

10. It is clear that the EU Treaty, as interpreted in a number of cases decided by the European Court of Justice (ECJ), is going to have a major impact on the structures of the tax systems in all the EU Member States.

11. We believe that hitherto the UK Government has not given this issue the importance that it deserves and has until now reacted in a piecemeal manner. In order to seek to address these issues we worked with other representative bodies and produced a joint paper in November 2001 ‘Discrimination and UK Tax Legislation following recent decisions of the ECJ’ which was discussed at meetings with the Revenue. In that paper, we warned that unless these issues were addressed at an early stage, the UK tax system would be beset by major problems. Developments at the ECJ since then have confirmed that our fears were well grounded.

12. Nonetheless we welcome the fact that the UK Government has now taken steps to address some of these issues in the current Consultation Document. We note that it is the first EU Government to do so.

13. The Consultation Document considers changes to the existing Transfer Pricing and Thin Capitalisation rules and invites comments on the 'wider international issues'. We have set out in 'The wider context' section below what we consider to be the more important of these issues.

14. We consider that these issues ought to be tackled on an EU wide basis as similar problems face all the EU Member States, including the accession countries that will be joining the EU next April. We also believe very strongly that it would be premature to extend the existing transfer pricing and thin capitalisation provisions until the many issues surrounding these proposals have been resolved. We are aware that the European Commission has been offering to co-ordinate discussions as to how to overcome these problems on a consistent basis throughout Europe. We hope that the UK Government will adopt a more pro-active role in conjunction with the other EU Member States to confront these issues.

*The length of the Consultation process and its content*

15. Whilst we welcome the Government's willingness to consult, we are not convinced that sufficient notice has been taken of the responses to the earlier consultation exercise.

16. For example, in paragraph 14 of our earlier response, we noted in relation to the proposals on the taxation of capital assets that:

    '…..Whilst we do not necessarily disagree with the economic case for change as set out in chapter 2 of the Consultation Document, there is not enough detail in the Consultation Document to gauge the danger of increased complexity. The current system is tried and tested and the case for change must be overwhelming. The rewards of reforming the system do not appear to outweigh the disadvantages and our conclusion is that the existing system should be retained.'

17. We are therefore disappointed that in spite of strong representations for no change to be made in this area, the present Consultation Document still proposes to take forward reforms.

18. Underlying the proposals is a general discussion as to whether tax ought to follow more closely the results reflected in the company accounts. We feel that this is not the right time to be discussing a move in that direction, when there is a major move towards the adoption of International Financial Reporting Standards (IFRS) from 2005 onwards and when the future form of those standards and their suitability as a basis for taxation remains unclear. As the Consultation Document itself states 'To ensure that all potentially relevant issues are identified, a co-ordinating group has been set up under the auspices of the Business Tax Forum.' The Tax Faculty, in conjunction with the CBI, issued a major paper in August this year on 'The implications of adoption of IFRS for the UK tax system' which has

been the basis for the discussions at the two meetings of the Business Tax Forum that have been held so far.

19. In our view it is premature to continue to debate potential changes to the tax treatment of capital assets when there are so many issues arising in this area from the introduction of IFRS that need to be addressed.

20. Once again our conclusion is that the existing system should be retained.

*The taxation of unincorporated businesses*

21. We continue to be concerned at the differences that now exist between the taxation of companies and unincorporated businesses. The difference between the two has grown steadily since 1998 and the current proposals will, in effect, result in a complete divorce between the two systems. We remain unconvinced that this is a development to be encouraged, not least because it creates anomalies and will result in unfairness.

22. The Government has moved to this two tier system with little if any debate about whether this is right in principle. We are not convinced that it is. If the Government believes that businesses should operate within a corporate structure, then we would appreciate the opportunity to debate the issue rather than the Government apparently attempting to influence this development through piecemeal changes to the UK tax system.

*THE CONSULTATION DOCUMENT*

*Developments in Accounting Standards*

23. We believe that the accounts should continue to be the starting point for the determination of taxation liabilities. However we are equally conscious of the potential impact of the move towards adoption of International Financial Reporting Standards (IFRS) which will be mandatory for listed companies from 2005 and may be adopted more widely by unlisted companies under the current proposals of the DTI. We have mentioned above the discussion paper "The implications of adoption of IFRS for the UK tax system (TAXREP 27/03) which we have produced in conjunction with the CBI and which has already formed the basis for two meetings with the Revenue.

24. We note at the end of our discussion paper:

> "Consultations on the tax consequences of IFRS should not be divorced from continuing consultations on the reform of corporation tax generally. There must be joined-up thinking in this area. It is important that they should inform each other. It is interesting that the introduction of the new regime for intellectual property, which is aligned closely with accounting practice, took place with no reference to the possible changes in accounting practice that adoption of international accounting standards would entail."

25. These two issues are interlinked and no changes should be made without first examining the likely impact of moving over to IFRS.

*Schedular reform*

26. We believe that the abolition of the schedular system and in the longer term a system of full pooling should be the policy objective. However we recognise that for practical reasons it may not be possible to achieve this at a single go in which case the immediate objective should be the revision of the loss set off rules. We do not believe that the separate sources method, paragraph A.13 of the Background Notes, will achieve anything.

27. We recognise that the losses that have accumulated at the time of any change to a full pooling system represent a major issue. We believe that the ideal would be for full pooling of such losses but we recognise the considerable cost of such a move. It would have been helpful if the current Consultation Document had given an indication of the estimated amount of such losses. The figures from paragraph 4.14 of the 2002 Consultation Document indicate that corporate tax losses to carry forward as at 31 March 2001 would be of the order of £100 million. It would be helpful to know if this is still a reasonable figure, and what the equivalent figure is likely to be as at 31 March 2003. It would also be helpful to have some estimate of what proportion of such losses might actually be used in practice as we suspect that quite a lot of this loss figure might relate to failed trades and so is unlikely to be used.

28. In terms of the options set out in paragraph A.49 we favour an elective percentage approach, along the lines of the third option.

*The tax difference between trading and investment companies*

29. As mentioned in TAXREP 29/02, we believe there is a clear case for abolishing the existing distinction.

30. We also believe that the ‘wholly and exclusively’ test should be reformed. We stated in paragraph 44 of TAXREP 29/02 that this frequently causes problems in practice and we questioned whether the rule is needed. We remain of that view.

*Capital assets*

31. The proposals in this part of the Consultation Document cover a range of issues, namely:

    Accounts as the basis for tax computations
    Land and buildings – particularly relief for the cost of commercial buildings
    Rollover relief
    Plant and machinery – and in particular depreciation/capital allowances

Shares
Pooling of capital and income gains and losses
Controlled Foreign Companies
Leasing

32. As noted above, we remain unconvinced, as we were in response to the 2002 Consultation, that this is the right time to make changes in this area. In particular it is now apparent that the move to IFRS is likely to have a major, but as yet undetermined, effect on the tax position of companies.

33. We said in our response to the 2002 Consultation, TAXREP 29/02:

> The result [of recent major changes in the corporation tax legislation] is that companies have recently had to cope with several radical changes to the corporation tax system. Our overriding concern is therefore to ensure that any further reform leads to a real simplification of the existing system, which for the vast majority of companies and situations is reasonably well understood and does not create undue difficulties. If this result cannot be demonstrated, then the reforms should not be taken forward.
>
> …….
>
> Whilst in theory the proposal to tax all gains as income has some logic, we are concerned that legislation could result in a more complicated system. In other words, we will have swapped a complicated but familiar system for one which is even more complicated and is unfamiliar. The complexity of the legislation which was found to be necessary to bring intangibles into the income regime illustrates the scale of the problem. We find it difficult to comment at this stage without some indication of the sort of change that would be proposed.
>
> In our view, the requirement for a simple system is paramount. Whilst we do not necessarily disagree with the economic case for change as set out in chapter 2 of the consultation document, there is not enough detail in the Consultative Document to gauge the danger of increased complexity. The current system is tried and tested and the case for change must be overwhelming. The rewards of reforming the system do not appear to outweigh the disadvantages and our conclusion is that the existing system should be retained.

34. We consider that those comments still apply to the present proposals. In particular we do not believe that they comply with two of the Tax Faculty Ten Tenets, namely Simplicity and Constancy. The further details in the latest Consultation Document do not allay our previous concerns about the likely complexity of the proposed system, nor in our view does the document put forward sufficient justification for the change.

35. We understand that in relation to the 2002 Consultation there were many other representations in addition to our own which were not in favour of the proposals

in this area. The current Consultation Document indicates – paragraph 2.8 – that the responses to the earlier Consultation were more mixed in this area by contrast to the favourable reaction to the other two proposals. It is perhaps not surprising that the proposals received "some support" (paragraph D.22), since there would no doubt be some significant winners, but we do not believe they would be beneficial to business as a whole.

36. Many capital assets are held for long term strategic and commercial reasons so if the proposals were adopted any interim increase in value should at least not be taxed until such assets are sold, if they ever are. Clearly the change to IFRS is also going to affect the situation particularly to the extent to which fair value accounting will in future recognise non realised increases in value in the accounts. As mentioned above we have prepared a paper on the implications of IFRS for the tax system which we are already discussing with the Inland Revenue. The CT Reform proposals need to take into account the accounting changes to be brought about by IFRS.

37. The suggested move from the present system of capital allowances to allowing a deduction for commercial depreciation would also involve a substantial shift in favour of some sectors and against others. While this may not necessarily be undesirable in terms of economic efficiency, it should not be undertaken lightly. Consultation on this aspect of the proposals needs to be informed by a full economic analysis of the likely consequences, which so far as we are aware has not yet been prepared.

38. In the case of buildings we understand that if there is a move to follow book depreciation, or a revamped capital allowances system is introduced, then tax relief is likely to be based on the price paid for the building by the current owner rather than being based on the historic cost as under the existing Industrial Buildings Allowance system. This would be a natural consequence of following book depreciation but either way this would be a welcome simplification.

39. If in spite of our comments above the taxation treatment of capital assets was reformed we feel that the regime for the taxation of intellectual property which was introduced in FA 2002 might provide a suitable model. It would also have the advantage of consistency.

*Leasing*

40. We do not believe that the leasing proposals properly recognise that the leasing industry is largely predicated on the existing reliefs under the capital allowances regime and that it has hitherto been a well accepted form of investment incentive. To change the system, even if this produces a purer and more logical substitute, would have potentially a serious and disadvantageous effect on the level of investment in capital assets in the UK. This could have a serious impact on the competitiveness of the UK economy which could undermine the Government's long-term goal of increasing the sustainable rate of UK productivity growth (paragraph 1.7).

41. We note that the Finance and Leasing Association are instructing Oxford Economic Forecasting to undertake a research project into the impact of capital allowances on investment and that the Revenue's own economists are carrying out a similar study. This empirical evidence should be taken into account before any decision is reached on potential change to the current leasing regime.

*The wider context – transfer pricing, thin capitalisation and looking further forward*

42. We are concerned that the Consultation Document addresses only two of the issues, transfer pricing and thin capitalisation, where UK legislation is potentially out of line with the EU Treaty and the decisions of the European Court of Justice (ECJ) and the European Court of Human Rights (ECHR).

43. There are a number of other areas where the UK tax system may not be compliant with the EU Treaty of which the more important areas of concern to the corporate sector are:

    Cross Border Loss Relief
    Group Transfer of Assets
    Demergers
    Company Migrations
    Controlled Foreign Companies

44. We appreciate that some of these issues are subject to current litigation and that is seen, we understand, as a reason for not proposing any change at the present time. But Thin Capitalisation is also subject to current litigation and the Government has felt able to make proposals for change in the present Consultation Document.

45. As we have said in the section above 'Some additional concerns – The International Context' we believe the UK Government ought to be working with its EU counterparts and the European Commission to find a common way to make Member States' domestic tax laws consistent with the EU Treaty.

**APPENDIX 1**

**Answers to specific questions**

**Rationalisation of the Schedular System**

***Types of pooling***

1. What would be the extent of the benefits delivered by full pooling?

A tax system with full pooling will be considerably more straightforward and will make tax computations much easier to prepare. This will be a considerable advantage to Small and Medium Enterprises (SMEs) in particular. There will also be much greater flexibility in the use of losses.

Full pooling would also in effect mirror the way in which accounts are drawn up, as there is no segregation of sources within the accounts themselves and any losses are therefore automatically set off against profits from whatever source.

2. What would be the extent of benefits delivered by pooling all sources of trading income and income from property?

There would be equivalent, but slightly reduced, benefits to the full pooling option.

3. Would there be disadvantages in either form of pooling, or any difficulties in implementation?

There would be some potential disadvantages in terms of obtaining double taxation relief but this could be overcome by appropriate structuring of overseas investments.

4. Should the scope of trading-letting pooling be as defined in [the] background note, or should the boundaries of the pool be changed?

We believe that if trading-letting pooling is adopted then the pool should be extended to include incidental investment income received as part of the trading/letting activities. This would avoid the need to create a separate pool for the large number of companies, particularly SMEs, which have only trading and/or letting activities and a small amount of incidental interest income.

5. Would it be better to combine items outside the trading-letting pool into a single pool, or to keep them in their current separate categories?

It would be better to combine items outside the main pool(s) as the fewer the pools the better.

***Loss relief***

6. What loss relief rules would be appropriate for each type of schedular reform?

We believe that the proposals set out at paragraphs A.22 to A.30 in respect of trading-letting pooling and A.31 to A.34 in respect of full pooling are reasonable, except that we have some reservations about the implication in paragraph A.30 that management expenses would necessarily be allocated to the non trading-letting pool. In a company which has both trading and investment activities there will be some expenses which relate to management of the corporate entity itself rather than specifically of its investments. These should be allowable against total profits, in-year or carried forward, in the same way as management expenses of an investment company under the present rules.

7. **If relief for pre-commencement losses had to be limited, what would be the best way of doing so?**

As we have said in our general comments above in respect of schedular reform we favour the third option set out at paragraph A.49, an elective percentage approach.

8. **On the transfer of an activity to another company in common ownership, would it be better to identify a proportion of losses within a pool to transfer or to leave losses with the original company? If the former, how could the proportion of losses best be computed?**

We believe that an appropriate portion of the loss should be transferred to the associated company on a transfer of activity. We accept that this portion of the overall loss would have to be based on a rule such as 'such apportionment as may be just' (paragraph A.37). It is worth noting that such an apportionment is already required under the existing system when part of a trade is transferred so it should not pose too great a problem.

9. **What treatment of losses would be appropriate on a change in ownership of a company?**

We believe that the existing rules should be retained, modified as appropriate to reflect the fact that following schedular reform the results of individual trades would not be separately identified for tax purposes. The rule would therefore have to be expressed in terms of a major change in the nature or conduct of the company's business (or its trading-letting business if that is separately pooled) rather than of any particular activity.

This could be to the disadvantage of companies which have a major change in a non loss making activity, amounting also to a major change in the business as a whole, which could trigger the anti-avoidance provisions even if there has been no change in the trade which actually generated the loss. It could on the other hand be seen as being to the disadvantage of the Revenue on the grounds that a major change in the business as a whole is a higher threshold than a major change in a particular trade which forms a constituent part of that business. The Consultation Document seems to take that position. However we think it is incorrect. A "major change" is in any case not defined in quantitative terms, and we believe that the sort of manipulation which amounts to a major change in the trade would necessarily also be viewed as a major change in the business as a whole, except perhaps in the rare case where the trade is an entirely *de minimis* part of the business.

***Specific types of expenditure and income***

10. How should pre-trading and pre-letting expenditure be treated?

We do not believe there should be special rules for pre-trading and pre-letting expenditure when there is general pooling or trading-letting pooling so that companies are taxed by reference to a single source. If a company is already active such that a "single source" is in existence then there should be immediate relief for any particular "pre-trading" or "pre-letting" expenditure which could be attributed to a new activity. This is akin to the current position when a company incurs expenditure with a view to launching a new product or opening a new branch within a single Case 1 trade. There is no valid argument to the effect that relief should be deferred just because for instance the expenditure is not likely to lead to taxable profits until some time in the future.

11. What would be the most appropriate approach to double taxation relief computations?

It is already necessary to carry out an apportionment when part of the Case 1 computation qualifies for Double Taxation Relief and part does not. A 'fair and reasonable' apportionment should be applied under the new regime.

***Specific types of business***

12. How, if at all, should conditions for shareholder investment incentives be amended to preserve their broad effect following schedular reform?

We do not believe any significant change is required. The future test could still be by reference to whether or not the company was carrying on a qualifying trade despite the fact that the taxation of that company would no longer be by reference to its particular trades.

13. How should mutual business be treated?

We believe the mutual principle could be extended to letting income to overcome any potential problem and the need to segregate trading and letting income. Although the tax exemption of mutual businesses has historically developed in the context of trades, we do not see any reason in principle why the same rule should not apply to mutual letting.

14. In what ways, if any, should schedular reform affect the treatment of life assurance?

We anticipate that the life assurance industry will comment on this question.

15. Would treating non-North Sea upstream oil and gas trades in the same way as other trades give rise to any special issues?

    We anticipate that the North Sea oil companies will comment on this question.

    ***Administrative costs and savings***

16. What would be the likely compliance cost savings to companies from trading-letting pooling and from full pooling?

    While we believe there will be some cost savings we do not now believe that these will necessarily be significant.

17. How would these savings affect small, medium and large companies differently?

    To the extent there are savings these are likely to be proportionately more significant to smaller and medium sized companies.

18. How would sectoral issues affect the savings?

    We cannot see how sectoral issues would have an impact on potential compliance cost savings.

19. Would the schedular reform proposals reduce the amount of recordkeeping that companies had to do, and what savings would follow from this?

    We do not believe the reform would have a significant impact.

20. Would any of the possible changes to the schedular system produce any ongoing additional compliance costs for companies? How?

    The way in which pre commencement losses are treated and the need to monitor their amount in the future would create additional work and costs and add an element of complexity.

21. Would changes to the schedular system produce any one-off costs relating to restructuring activity? How?

    We do not think that the changes would involve any such costs in themselves. Some groups may undertake restructuring in order to take advantage of the new system, for example combining previously separate activities into a single company, but since such restructuring would only be undertaken if the costs were thought to be outweighed by tax savings we do not think that they can properly be described as costs attributable to the change in the tax system.

    **The tax differences between trading companies and**

**investment companies**

***Expenses rules***

22. Comments are invited on the possible removal of the requirement to qualify as an investment company in order to obtain relief for the expenses of managing investments. To what extent would group re-structuring be facilitated by such a change?

We would welcome a change that eliminated the need for companies to qualify as investment companies before they can obtain relief for the expenses of managing investments. We also believe this would remove a potential obstacle to restructuring as companies would no longer need to concern themselves as to whether the restructuring had created a hybrid company, as is a potential concern under the current regime.

23. Comments are invited on the possible closer alignment of the management expenses rules with the accounting treatment (for example, by following the accounts in relation to the timing of the deduction). Would there be any disadvantages in such a change?

We support the closer alignment of management expenses with the accounting treatment and can see no disadvantages from the change.

24. What would be the practical effects of these changes for companies?

Tax will no longer potentially drive commercial decision making.

25. How would the changes affect different sectors and sizes of company?

We do not believe the changes will have a different effect depending on the sector or size of company except to the extent that larger companies are more likely to have problems under the current regime.

26. Do respondents see any issues arising from the interaction between these changes and the proposed reforms of the schedular system and the taxation of capital assets?

If there is a partially pooled system then there could be problems allocating management expenses between the separate pools.

27. Comments are also invited on the idea of a single business expenses rule. What would be the preferred form of such a rule?

We are in favour of a single business expense rule so that all expenditure incurred wholly and exclusively for the purposes of the company's business, with the possible exception of capital expenditure (but see *Camas plc v Inspector of Taxes*), should rank for relief. We are not sure why this change is likely to have a significant Exchequer cost (paragraph B.29) but if it does this is a good reason for the change as it is likely that a significant amount of legitimate business expenditure is currently not qualifying for relief. The form of such a rule should be subject to further consultation.

28. What modifications to the special rules for management expenses of insurance companies might be included in any general changes to the management expenses regime?

See question 14 above.

***Substantial shareholdings exemption***

29. What would be the benefits of the possible extension of the substantial shareholdings exemption to shareholder companies that are investment companies? Would there be any disadvantages?

We believe that the substantial shareholding exemption (SSE) exemption should be extended to shareholder companies that are investment companies. This would allow greater flexibility for investment, and disinvestment, in the corporate sector which is one of the major objectives of the SSE regime. It would also avoid uncertainty for certain investing groups, whose status as trading groups may be unclear.

We note that this is already the position in many European Union countries and the change would assist the UK to compete on more equal grounds with those countries.

30. Comments are invited on the Government's view that avoidance concerns would make the extension of the exemption to non-trading investee companies too risky.

We do not believe that the change would undermine the basic rationale of the SSE regime. Many other countries allow a participation exemption for non-trading companies, apparently without major adverse revenue consequences, and this change too would improve the competitive position of the UK. If there are abuses then these could be counteracted by appropriately targeted anti-avoidance provisions. It may be that close investment holding companies would need to be excluded, to prevent the use by individuals of the corporate tax exemption.

31. Are there other aspects of the exemption which you think the Government should examine in the context of corporation tax reform?

We do not believe there are any aspects of the exemption that should be examined in the context of this particular Consultation.

***Other issues***

32. Looking towards the future, which other shareholder reliefs would business identify as a priority for review (assuming that the current distinction was no longer required for Exchequer protection)? What

would be the likely effect on business of removing the distinction in these areas?

The reliefs which are of a more structural nature, in particular demergers, purchase of own shares and also consortium relief, should be looked at as a priority. We believe the other reliefs mentioned in paragraph B.40, which are of a venture capital type, are driven by different policy objectives and so are not connected in the same way with the subject matter of the current Consultation.

33. What new anti-avoidance provisions would respondents be prepared to see introduced in order to facilitate such changes?

We would be very happy to attend a meeting to consider such issues once the first stage changes have been decided on and the Government is engaged in a more general review of, for instance, the demerger and purchase of own shares regimes.

***Administrative costs and savings***

34. What would be the likely administrative cost savings for companies from the proposed changes to the expenses rules?

The administrative cost savings are likely to be relatively modest except in the case of companies which under the current regime could be caught up in lengthy and expensive arguments about whether or not they are an investment company.

35. How would these administrative cost savings affect small, medium sized and large companies differently?

We do not believe there would be any significant difference.

36. How would sectoral issues affect the administrative cost savings?

We do not believe there would be any effect.

37. What would be the likely administrative cost savings from the removal of the substantial shareholdings exemption trading restriction at the level of the shareholding company?

We cannot see there would be any administrative savings except, again, in the case of groups which may under the present rules be involved in expensive arguments about their trading status.

**The taxation of capital assets**

***General approach***

38. To what extent would it be appropriate to use the accounts as a starting point for the computation of capital profits? What exceptions from accounts treatment would be appropriate?

As we have mentioned in our general comments we believe in general that the accounts should be the starting point for the determination of taxable profits.

However substantial adjustments may still be required to the accounts figures in order to satisfy the requirements of fairness and competitiveness, as well as providing any more specific tax incentives which Government may consider appropriate. Any change in the tax treatment of capital profits will have to take into account the prospective changes to IFRS and, in particular, the move towards fair value accounting. We believe that any accounting change that causes unrealised profits to be recognised in the accounts needs to be reviewed before that profit is accepted as taxable. This is explicitly recognised in paragraph 2.37 in relation to investment properties - "Any new regime would therefore impose payment of tax on appreciation of real property only on disposal".

In our paper reviewing changes to IFRS we identified a number of areas where this could cause a problem. These include:

- financial instruments and hedging
- investment properties
- biological assets

Where capital assets are disposed of in many instances the proceeds will be required for reinvestment in the business. The existing system of rollover relief ensures that there is no immediate tax liability in these circumstances. If the profit is in future subject to corporation tax there would, in our opinion, have to be some equivalent of rollover.

The Consultation Document takes the position that withdrawal of indexation relief would be a necessary consequence of the proposal to tax capital profits on the basis of the accounts. In our view this skews the overall package significantly in favour of the Revenue, and is a further reason for rejecting it. Indexation relief was introduced to mitigate the unfairness of taxing companies on inflationary gains, and that principle remains valid even though the inflationary element is currently much less than it was. Although on a global basis the removal of indexation relief might be regarded as a *quid pro quo* for allowing relief for the cost of buildings which do not currently qualify, there is no logical relationship between the two things and they will not always affect the same taxpayers.

***Land and buildings***

39. What would be the relative advantages and disadvantages of relief for the cost of buildings based on commercial depreciation (as outlined in paragraphs C.28 and C.29) or based on a fixed rate of annual allowance (as outlined in paragraphs C.30 and C.31)?

If commercial depreciation is used then this is going to encourage companies to write off their buildings over a shorter period with consequential pressure on auditors as to whether such a level of write off presents a 'true and fair view' (assuming of course that the accounts of the company are subject to audit). A fixed rate allowance would be inflexible and wouldn't necessarily reflect the particular circumstances of the business. Overall we accept that commercial depreciation is probably the better measure.

40. Would moving the boundaries between items qualifying for plant and machinery allowances and those items qualifying for the new building allowance produce a more coherent and sensible division of costs? Are there any potential problem areas?

There would be some advantage in overcoming the current demarcation disputes as to what part of the capital expenditure relates to the building and what part qualifies for plant and machinery allowances. However the nature of buildings today is such that a considerably greater proportion of costs are accepted as qualifying for plant and machinery allowances than in the past. So the rate at which buildings are to be depreciated under any new regime should reflect this reality. The relief of 6% put forward in paragraph C.31 is certainly too low if it is to be applied to the total cost of the building, including items which are currently treated as plant, and would need to be increased. We would recommend that a research project should be undertaken, with outside property specialists, to determine the nature of current buildings and the split of capital expenditure between the part of capital expenditure that ranks for plant and machinery allowances and the part that represents the building.

Any new boundary would still potentially raise new areas of dispute at the margin. However a boundary based on the land law definition would probably be clearer and more logical than the present one, and using an existing legal definition has the advantage that many of the grey areas have already been explored in the case law.

41. Comments are invited on the proposals for a new form of roll-over relief.

We believe that a form of roll-over relief along the lines of that currently provided under the intangible assets regime would be acceptable.

***Plant and machinery***

42. Would economic efficiency be improved by a system of relief for capital expenditure which aimed to reflect economic depreciation more closely?

The public studies that have looked at UK productivity by comparison with countries such as France and Germany show that those two countries have higher productivity and a higher level of capital investment. If productivity is a reasonable measure of economic efficiency and if increased capital investment results in increased productivity then the UK should be looking to a system of relief for capital expenditure which encourages increased expenditure on capital assets. However, the relief should not be so overgenerous that it encourages unproductive investment.

The proposed change would broadly favour investment in shorter-life assets, possibly therefore favouring "high tech" industries, at the expense of investment in heavier, infrastructure assets which may be less fashionable but are still essential to the functioning of the economy.  It is hard to say whether or not that would be desirable, but even if it is the suggested change in the tax system may be an unduly blunt instrument for the purpose.

43. **If it is considered desirable for relief to approximate more closely to economic depreciation, how might this best be achieved? By allowing relief for commercial depreciation as shown in the accounts; or by modifying the capital allowances system, for example increasing the number of different rates?**

We do not favour increasing the number of rates. The relative simplicity of the present system of capital allowances is a major point in its favour.

It follows that if relief is to approximate more closely to economic depreciation the relief should be by reference to the commercial depreciation as shown in the accounts. However if commercial depreciation is the measure of relief then it will be extremely difficult in practice to apply differential rates to different types of investment for tax incentive purposes.

44. **To what extent do capital allowances influence the level and timing of**
investment in practice?

Any company making a significant investment is going to carry out a cash flow exercise to evaluate the rate of return on the proposed investment. The tax benefit is going to be an element of this calculation and more generous tax reliefs will influence the decision whether to invest or not.

Whether the tax relief actually determines whether or not a particular investment is made will of course depend on the figures. The difference between getting tax relief in some form and getting none at all may well be decisive. Relatively small timing differences, such as the 40% first year allowance, are much less likely to be decisive, particularly for a company paying tax at the small company's rate or not paying tax at all.

As far as timing is concerned the current system encourages companies to invest just prior to the year end so that the capital allowances fall into the current, rather than the following, year.

45. **To the extent that capital allowances do have an influence, what features of the capital allowances system are most important? Is it, for example, the rate of allowance, or other factors such as the flexibility or certainty of the regime?**

The rate of the allowance is the most important single factor. A valuable feature is the flexibility to disclaim part of the allowance.

46. **What features of the current capital allowances system are attractive to business for other reasons?**

The system has been in place for many years and much of it is well understood and certain, which assists businesses in forward planning.

47. What are respondents' views on the options to deliver specifically targeted, enhanced allowances within a depreciation regime?

We believe that this would be much more difficult than with the current system of capital allowances. It would certainly eliminate any benefit from the change of system in terms of simplification.

***Shares***

48. Comments are sought on any specific rules that respondents would wish to see retained.

The reliefs in relation to take-overs and reconstructions should be retained, insofar as these would otherwise be chargeable events under any new system.

49. Comments are also welcome on any other issues arising from the proposals, including their interaction with the substantial shareholding exemption.

We do not believe that strategic holdings in other companies, that are not covered by the SSE exemption, should be taxed before the shares are realised (paragraph C.58). Indeed, if indexation is to be removed (paragraph 2.41) we believe that the extension of SSE exemption to all subsidiaries and other strategic holdings should be the quid pro quo.

***Pooling of capital profits***

50. What are respondents' views on the three options to deal with profits and losses on disposal?

We believe that capital losses should go into the general pool and they should not be segregated in a separate pool (paragraph C.70) or be excluded (paragraph C.71).

51. How would each of these options affect the benefits of schedular reform (either trading-letting policy or full pooling, as set out in Background Note A)?

We believe that general pooling of capital losses is a logical extension of the general pooling proposal.

***Transition***

52. Comments are invited on the options for transition.

The suggestion is made in paragraph C.84 that if losses brought forward into the new regime are to be brought into the general pool they would only be available to set off against gains made on assets held at the start of the new regime. This would be totally unacceptable. Companies' existing rights and expectations must be preserved. In order to have an equitable system companies must have the option of setting off the "legacy" losses against any future capital gains, computed under the old rules Although this would involve some complexity, companies would not be obliged to claim the relief if they did not think it worthwhile, and even the proposal in paragraph C.84 would not be particularly simple to operate.

53. What are the most important factors that any design for transition should address?

That existing expectations concerning tax treatment are preserved as far as possible and that taxpayers are not disadvantaged by any changes to the rules.

54. Would different asset types benefit from different transitions?

We do not believe it would be acceptable to have different regimes for different asset types, in view of the additional complexity involved.

***Controlled foreign companies***

55. Should the CFC regime be modeled as closely as possible on the wider regime, or should it seek to replicate only those elements which are readily transferable?

As is noted at paragraph C.87, the original CFC regime excluded capital gains on the grounds that to include them would have been uncompetitive. We believe that argument is still valid and gains should continue to be excluded.

56. The Government would also welcome views on any implications specific to CFCs arising from other reform options highlighted elsewhere in this document (for example, the adoption of IAS).

We believe the Government also ought to take account of the fact that the current CFC regime, as it applies to EU Member States, is probably contrary to the EU Treaty.

In that context we believe that a CFC regime targeting specific categories of income would be more defensible than the current territorial approach. Such measures would presumably have to deal in the same way with equivalent income in the UK.

***Life companies***

57. Comments are invited on the possible options set out for life assurance companies.

    See our comment to question 14 above.

***Administrative costs and savings***

58. What would be the effect on compliance costs of the various options for the taxation of capital profits and relief for capital expenditure set out in this background note?

    There could be implications for administrative costs if there are multiple rates.

59. How would any administrative savings/costs affect small, medium and large companies?

    We believe that administrative costs are likely to have a greater proportionate effect on small businesses than larger businesses.

60. How would any administrative savings/costs affect companies in different business sectors?

    This would depend on the eventual form of the proposals. For example any reduction in costs resulting from removal of boundary issues as between buildings and plant would obviously benefit mainly the property and insurance sectors.

***Leasing (Chapter 2)***

61. What are respondents' views on giving capital allowances to lessees for leases which are essentially financing transactions?

    It is accepted that many lease based transactions are essentially funding transactions and represent an "alternative" to loan finance for the lessee. However, this does not of itself create a reason for giving the capital allowances to the lessee.

    A lease is a different transaction, even though it achieves a similar economic result in many circumstances. However, there are leases where the security of the asset is an important factor in either setting the implicit interest rate or enabling the transaction to take place at all, both because of the credit worthiness of the lessee. In addition, many prospective lessees, particularly in the early years of UK operation (especially inward investors) and in periods of exceptionally heavy capital equipment expenditure, have no or insufficient taxable profits to obtain the benefit of capital allowances for many years. For these companies, the cash flow advantage of a lease rental reduced by the availability of capital allowances to the lessor, can be of crucial importance.

It is thus believed that, as a minimum, capital allowances should properly fall due to the lessor not just in "real" operating leases, but in funding transactions where ownership is a genuine factor in the transaction and where it provides a much better incentive to investment in capital assets than would be the case if the user were to be entitled to the allowances.

62. What practical difficulties might be faced and how might they best be overcome?

There are enormous practical difficulties involved in devising different rules for different categories of lease. The current accounting definition alone does not always give total clarity (especially when the subjective test of FRS 5 is applied) but a new, tax only, category of "funding lease" would create either uncertainty or unfairness, or possibly both.

It is thus suggested that a single system be used which initially gives the capital allowances (or tax depreciation if the system moves to an accounts basis of writing off capital assets) to the lessee if it has the asset on the balance sheet of its statutory accounts, but with an elective system which would enable any lessee entitled to claim such capital allowances to jointly elect with the lessor that they should fall due to the lessor.

It is believed that this approach, giving the basic entitlement to lessees in many cases, with clear provisions (broadly similar to those in section 177, CAA 2001) to transfer the entitlement to the lessor, will give simplicity, certainty, fairness and that this should also deal with the difficulty which the present UK provisions relating to cross border leases may face in European law.

It is accepted that this point of potential challenge in the ECJ needs to be addressed to protect the UK Exchequer.

***The wider context (Chapter 3)***

63. What will be the effect of extending the transfer pricing rules to UK/UK transactions?

Extending the transfer pricing rules to UK/UK transactions clearly increases the potential burdens on UK business, particularly on SMEs who are less likely to be involved in international trade and so not affected by the current transfer pricing regime. We comment in relation to question 64 below on the measures which the

Government has put forward to minimise the administrative burdens.

64. How could the administrative requirements best be mitigated, particularly for smaller businesses?

We would support the introduction of an assets/employees/turnover threshold based exemption which would assist SMEs and take most small enterprises out of the system. We understand the Government believes, on the basis of legal advice it has received, that companies can be subject to a risk based assessment in relation to transactions undertaken with low tax countries. We nonetheless are concerned that such a risk assessment could be viewed as distinguishing between EU Member States on grounds of low taxation which we understand to be contrary to the EU Treaty.

If such a risk based assessment were determined not to be contrary to the EU Treaty then we would welcome the publication of the Revenue’s internal risk assessment guidance as was proposed at the meeting with the Revenue which took place on 14 October 2003.

We also welcome the assurance that has been given that companies would only be required and expected to bring into existence documentary justification for their transfer pricing after an enquiry had been raised and not at the time of making a return. In that way transfer pricing documentation would be needed if, and only if, the company is the subject of an enquiry and not otherwise.

We note that other representative bodies have suggested a return to the pre-CTSA rule whereby the transfer pricing rules would be applied only where the Revenue make a direction. This is another approach which we believe is worth exploring further, particularly if the direction mechanism is framed in terms of the Revenue having to get a direction before they can instigate an enquiry. We would be happy to be involved in further consultation on this proposal.

64a[1] Would the publication of guidance along the lines discussed in Annex A of the subsequent discussion paper ‘Transfer Pricing – Documentation’ enable businesses to reduced the costs they decide to incur in complying with transfer pricing rules

We welcome guidance along the lines set out in the discussion paper ‘Transfer Pricing – Documentation’ and we believe that, in general, it represents a sensible first approach to a documentation standard. We would welcome further consultation on an appropriate standard. We also welcome the Revenue proposal that any internal guidance would be published.

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[1] This question is taken from the Transfer Pricing – Documentation discussion paper, paragraph 10.

64b [The Revenue] would like to know how important enterprises think it would be to attempt to secure a more standardized approach within the European Union. To the extent that it is important, how would this rank alongside the other objectives discussed in the discussion paper 'Transfer Pricing – Documentation'

We believe that having a standardized approach is extremely important, indeed it is probably the most important objective. This is particularly the case as a result of the enormous increase in the number of countries that have introduced documentation standards over the past 10 years or so. We understand that it is anticipated that the EU Joint Transfer Pricing Forum are aiming to produce a proposal early next year in relation to common documentation standards and we warmly welcome this, provided the common approach adopted is not unnecessarily onerous.

65. Are there any difficulties arising from the use of transfer pricing legislation in relation to interest paid by thinly capitalized companies?

We believe there are very serious difficulties. We would welcome exploration of a modified grouping rule which would, for instance, look at all the UK subsidiaries of a UK subholding company while ignoring the UK lending company. Similar rules would have to be adopted for intra EU lending/borrowing.

If the above is not feasible then we would suggest the option considered at the third representatives meeting should be explored further. This would involve reverting to the position which applied prior to the enactment of what is now section 212 ICTA 1988 whereby excessive interest paid even to a lender within the charge to UK corporation tax would be reclassified as a distribution, so there would be no deduction for the borrower but equally the lender would be treated as receiving a tax-free distribution.

We would be happy to discuss these and other possible options at a further meeting.

66. What are respondents' views on the issues raised in the final section of this chapter, taking into account the principles of competitiveness and fairness?

We believe that the changes to IFRS and the impact of the EU Treaty are going to have potentially profound implications for the UK tax system and will necessitate a careful review of the current system. We will be very happy to be involved in discussions as to the appropriate measures to be adopted to deal with these two issues.

We accept that the other issues listed in paragraph 3.20 are also likely to have an impact on the way the UK structures its tax system but their impact is less certain at the present time and we believe the two issues identified in the previous paragraph should be the immediate priority.

## APPENDIX 2

## THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.