Tax Faculty

Tax Representation

TAXREP 9/05

CORPORATION TAX REFORM

Response of the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Technical Note 'Corporation Tax Reform' issued on 2 December 2004.

CONTENTS

CORPORATION TAX REFORM

INTRODUCTION

1. We welcome the opportunity to respond to the Technical Note issued by the Inland Revenue on 2 December 2004.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales ('ICAEW') 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 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, including taxation.

4. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations 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.

KEY POINT SUMMARY

5. Whilst we welcome the continuing efforts of the Government to create a modern corporation tax (CT) system we are disappointed that so little progress has been made despite the consultations that have taken place over the past two and a half years. As in our earlier representation (TAXREP 40/03) we favour the full abolition of the schedular system and in the longer term a system of full pooling. We are not convinced that the limited reform put forward in the current Technical Note will provide major advantages for business.

6. We also note that the issues that are now before the ECJ may require such fundamental changes to the domestic tax regimes of all the EU Member States that in the short term any overhaul of the existing system may almost immediately require further, significant, change to reflect the ECJ decisions.

The general features of a good tax system

7. We believe that the Tax Faculty's Ten Tenets Towards a Better Tax System should underpin any review of the UK tax system and we discuss the most relevant Tenets below and reproduce them in their entirety in Appendix 2.

The impact of Europe and in particular the European Court of Justice (ECJ)

8. The decisions that have, or will, come from the ECJ may have a profound impact on our domestic tax system and we discuss the implications further below. We believe that a workable solution may only be possible if the problem is recognised at the highest level and if the UK Government works with the European Commission and the other Member States to seek a solution.

Different types of business structure

9. We welcome and support the approach shown in the recent Consultation Document *Small companies, the self-employed and the tax system* that the choice of legal form that a (small) business takes should reflect commercial rather than tax considerations.

The impact and cost of regulation

10. There is a considerable regulatory burden placed on UK business which we believe is not perhaps fully appreciated in formulating policy. We believe it is appropriate to commission an independent research project into the major burdens facing business so as to provide evidence of those areas where regulations have most impact on business.

11. We have set out our General and Specific Comments below and included in Appendix 1 our responses to the detailed questions in the Technical Note.

GENERAL COMMENTS

Background to the current Technical Note

12. The current Technical Note follows two Consultation Documents, issued in August 2002 and 2003, and a Technical Note issued in December 2003. We responded to these earlier Consultation Documents and Technical Note in TAXREP 29/02, TAXREP 40/03 and TAXREP 8/04 respectively.

The general features of a good tax system

13. The current Technical Note is concerned with the detail of CT reform rather than the general principles but we think that it is important not to lose sight of the general principles.

14. The comments we made in TAXREP 40/03 in respect of our Ten Tenets for a better tax system remain particularly pertinent and we have repeated them below. We believe that the Tax Faculty's Ten Tenets towards a Better Tax System should underpin any review of the UK tax system. We have reproduced the Ten Tenets as an Appendix to the present document.

> '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.

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.
>
> Taken as a whole the principles set out in paragraph 1.9 [of the 2003 Consultation Document on the Reform of Corporation Tax] are similar to those set out above.
>
> 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**.'

15. One clear indicator of the complexity of the UK tax system is the sheer volume of new tax legislation in this country. The UK has between 400 to 500 pages of new legislation each year. In contrast, for example, Germany, with a significantly larger economy than the UK, faces no more than 50 to 100 pages of federal tax legislation annually. We believe that this is in no small part due to the continuing complexity of our schedular tax system.

The impact of Europe and in particular the European Court of Justice (ECJ)

16. An increasing number of different areas of our tax system are potentially affected by decisions that have, or will, come from the ECJ. Our perception is that these have to a certain extent slowed down the process of corporation tax reform which began more than two years ago. The potential implications are not covered in the current Technical Note, but as is noted in paragraph 1.5 of the Technical Note, these issues have been the subject of separate discussions between the Revenue, taxpayers and Representative Bodies and they were also addressed in the CT reform plenary group meeting on 21 January 2005.

17. The consequences of these ECJ decisions may have profound implications for the structure of the UK corporation tax system and we welcome the opportunity to continue to work with Government in developing solutions which will be compliant with the EU Treaty. We are pleased to note that, generally speaking, the UK is at the forefront of those Member States which are seeking to adapt their domestic tax systems to be compliant with the EU Treaty.

18. It is also clear that these issues are of very considerably difficulty and we believe it would be worthwhile for the UK Government to seek to work with the European Commission and the other Member States with a view to exploring the extent to which there is scope to introduce some pan European 'solutions' which would be EU Treaty compliant. We appreciate that reaching a consensus on these issues is likely to be fraught with difficulty but given the developments at the ECJ the option of doing nothing does not appear to be available. If the UK Government acts unilaterally we are not optimistic that it will be possible to identify appropriate solutions, with the result that challenges to the UK tax system under the treaty will continue, posing a serious risk to the UK Exchequer.

19. We are concerned about the gravity of the problems faced by the UK as a result of the powers of the ECJ. In this context we note a comment by the Prime Minister in a recent speech to the effect that the UK retains 'full control of our domestic tax agenda.' The true position is somewhat more nuanced than that categoric statement because it does not reflect the fact the provisions of the EU Treaty take precedence over domestic UK legislation to the extent that there is a conflict. As noted earlier, there appear to be many areas where the UK tax rules do not appear to be in compliance with the EU treaty. Either UK legislation needs to be amended to ensure that it is compliant with the EU treaty or the EU treaty needs to be amended in some way. The political feasibility of the latter route, however, appears questionable.

Different types of business structure

20. The Government's policy since 1997 has been to introduce incentives for incorporated businesses as compared to unincorporated businesses. We appreciate that the issue of the differences between the tax treatment of incorporated and unincorporated businesses is not new, but the changes in the last eight years have created a bias in favour of companies. We noted this trend in paragraphs 21 and 22 of TAXREP 40/03 and questioned whether it was right in principle. The Government now appears to have moved its stance somewhat and in the discussion paper on *Small companies, the self-employed and the tax system* (published on 2 December 2004) at paragraph 1.7 there is the statement that 'The Government believes that the choice of legal form that a small business takes should reflect commercial rather than tax considerations.' This view is repeated at several other points in that discussion paper. We favour this more recent approach. We believe that unless there is a very strong reason why one particular business structure should be advantaged in a particular set of circumstances the tax system should seek to remain neutral.

21. We believe that the Government in reformulating the CT system should be mindful of the choices that business have as to the legal form under which they conduct their business. It is, for instance, becoming more common for businesses to establish

themselves as Limited Liability Partnerships and our members indicate that they believe this trend will increase.

22. We believe that the UK business tax system should be framed so as not to discriminate against the particular legal form within which the business operates. Where there are differences in treatment, we suggest the Government should investigate the case for electing in or out of a particular regime – e.g. an owner managed company might be given the option to be treated as a partnership.

Regulatory matters

23. We agree wholeheartedly with the Government position that its decisions should as far as is possible be evidence based.

24. We believe that there is a considerable regulatory burden placed on UK business which is not perhaps fully appreciated in formulating policy, but there is a pressing need for more evidence in this area. Since the Bath study[1] of taxpayer compliance costs which was undertaken and published some ten years ago, there have been no major studies of regulation and compliance costs in respect of any part of the tax system in the UK. In the absence of more concrete evidence, there is an inevitable presumption that the complicated UK tax system puts considerable burdens on business. In these circumstances we feel it would be beneficial if Government commissioned an independent research project into the major burdens facing business so as to provide evidence of those areas where regulations have most impact on business. We believe that the evidence from such a survey would provide Government with invaluable data to ensure that the reform of CT creates a regulatory environment which places no more than reasonable and proportionate compliance burdens on business.

Other matters

25. Although we appreciate that this is not related directly to the reform of CT, our members report that one of the major difficulties they are currently facing in dealing with their clients' strategic issues is caused by the potential impact of Stamp Duty Land Tax (SDLT). We feel that the implications of this new tax for relatively routine business tax decisions may not have been properly understood when the tax was introduced. For example, changes to the membership of a partnership which owns interests in land can now be inhibited because of the SDLT costs of doing so.

26. We would be happy to share our experiences of SDLT over a wider range of circumstances and set out our concerns that this tax may become a major disincentive on allowing businesses to adapt and change in the light of commercial developments, to the detriment of the UK economy as a whole.

DETAILED COMMENTS

Schedular reform

[1] Click here http://www.inlandrevenue.gov.uk/pdfs/bathv1.pdf to access the main report

27. We continue to believe, as we stated in our earlier representation TAXREP 40/03 - (paragraph 26), that the abolition of the schedular system and in the longer term a system of full pooling should be the ultimate policy objective.

Losses

28. We appreciate that one of the major problems is the level of accumulated losses and it would be helpful to have a better understanding of the scope of this issue. In the latest Technical Note it is stated that 'The total of companies' unused losses runs into tens of billions of pounds' (paragraph 2.32). The more detailed figures contained in paragraph 4.14 of the 2002 Consultation Document indicated that unused losses (which were said in the document to relate mainly to Schedule D Cases I and II[2]) available to carry forward to future accounting periods were about £100 billion as at 31 March 2001. The figure is presumably much greater at 31 March 2003 which is likely to be the most recent period for which such data is available.

29. We think it would be worthwhile keeping in mind the three options for use of 'pre commencement' losses which were set out in paragraph A.49 of the Background Notes issued in August 2003. These were:

1. the existing rules would apply to pre commencement losses; or
2. companies could elect to retain only a percentage of pre commencement losses on the basis that they would then be treated as if they had arisen under the new rules; or
3. pre commencement losses could be treated as if they had arisen under the new regime but only a certain proportion could be used in any one year.

30. In our response to the earlier paper (TAXREP 40/03), we favoured option 3. However, this was on the basis that all a company's income would be pooled. The proposal in this Note is more modest, namely combining trading and letting income with some miscellaneous income. In this regard, we note the intention that some miscellaneous income chargeable under Schedule D Case VI may be brought into charge under Schedule D Case I. At the moment the scope of this is uncertain as it is subject to Treasury regulations and there is no indication as to what such regulations may contain. We would appreciate clarification as to precisely what income it is proposed will be included in Schedule D Case I rather than Schedule D Case VI.

31. In the light of the current proposals we believe our earlier support for the proposal to relieve only a certain proportion of those losses in any one year needs to be reviewed. We now favour full pooling of losses arising from trading and letting.

Capital Assets

32. The proposal to treat capital assets under an income regime would eliminate indexation relief. This would be to the disadvantage of many businesses. The extension of buildings allowances to commercial buildings would broadly compensate most, but not necessarily all, taxpayers. Companies with significant investment property assets would, however, be particularly affected by the abolition of

[2] The Consultation Document refers to Schedule D Cases I and III but we presume it was intended to refer to Schedule D Cases I and II.

indexation. Any proposal also needs to consider the timing effect of lost rollover relief on cash flow.

33. We think the proposal to bring all proceeds into the capital allowances pool is a sensible simplification, provided, for example, a three-year 'grace period' is granted for deferral of tax on proceeds in excess of the pool, allowing regard to be had to reinvestment in the 'grace period'

34. In page five of the draft clauses: Requirement for profit etc paragraph 6(4): we do not see why a company should be taxed according to the way it carries on its business at the end of an accounting period. There should be apportionment (we accept it can work both ways i.e. be both advantageous/disadvantageous, but apportionment would be fairer).

35. The Treasury's powers under the regulations appear very wide and insufficient guidance is given in the comments on when they would be invoked in respect of Case D I versus Case D VI. We accept the approach is basically to enact the decision in *Liverpool, London & Globe v Bennett* [1912] 6 TC 375, but further clarification is needed.

36. The new section 74, ICTA 1988 (on page 10) still seems unnecessarily tight. Dual purpose expenditure should be capable of apportionment (not only where part of it is wholly & exclusively business expenditure). We think that the provision should be amended to clarify this point.

Cars

37. The proposals in this part of the document are of a very general nature at this stage and were the subject of a meeting with trade and representative bodies at a meeting on 1 February 2005.

38. We would welcome the removal of the £12,000 limit for capital allowances purposes (section 74 CAA 2001). When first introduced the limit applied to relatively expensive cars only but, as the value has not been indexed since it was raised to this figure in 1992, its real value has been eroded to the point where it now applies to most company cars. The result is that it imposes significant compliance burdens on business. For capital allowances, however, the limit represents only a timing difference because on the sale of the car there is no restriction on the balancing allowance and full relief is effectively given.

39. However for cars costing more than £12,000 which are hired, there is a permanent disallowance of part of the hire charge in accordance with the formula in section 578A, ICTA 1988. We understand that this disallowance benefits the Government by more than £100 million.

40. The current system for the taxation of expenditure incurred on the provision of cars costing more than £12,000 is cumbersome and the tax implications drive transaction decisions. As noted above, for the business owner/user of such a vehicle, the tax disallowance is merely a timing difference, whereas the lessee/user suffers a permanent disallowance. Furthermore, particularly when the lessor of a car costing more than £12,000 is a company providing a wide range of supporting services as

well as the car itself, it is common for there to be an intermediate lessee. In these circumstances, there is a double permanent disallowance.

41. We fully support the Government's policy purpose to reduce the level of CO2 emissions but this is already done through the employee benefit in kind charge and excise duties. We believe the Government ought to consider the full range of measures that it currently has in place, and others that might be relevant, in order to develop a coherent and consistent strategy in relation to cars with different CO2 emissions. The adopted system should be as clear and transparent as possible so that business and employees are clear as to the consequences of their choices.

42. If this proposal is not accepted, moving to a single restriction on the capital allowances available to the owner of the vehicle (whether a permanent or timing deduction) would give both fairness and simplicity. The qualifying capital expenditure could be restricted, based on some form of combined calculation taking into account both cost and environmental factors. It is a political matter as to whether this disallowance should be brought back in at the disposal of the vehicle or be a single adjustment at the outset. The use of a restriction based on the benefit in kind tables related to fuel consumption may be simple, although these tend to favour diesel cars. It is understood that the DVLA may be working on more widely drawn criteria for VED purposes, which would, for example, take account of diesel particulate emission levels, and this may be a more appropriate long term approach to the taxation of expensive cars.

Leasing

43. At paragraph 41 of TAXREP 40/03 we noted that the Finance and Leasing Association (FLA) were instructing Oxford Economic Forecasting (OEF) to undertake a research project into the impact of capital allowances on investment and that the Revenue's own economists were carrying out a similar study.

44. We understand the OEF report was presented to the FLA in January 2004 and its main conclusion was:

> 'The Corporation Tax proposals would reduce investment spending by temporarily unprofitable companies, including new starts, fast growing capital-intensive businesses and those in temporary difficulties, and would damage the investment environment for SMEs and inward investors, so undermining the thrust of other policies.'

45. It must be remembered that the report was a response to the proposals in the 2003 Consultation Document. The current Technical Note leaves the existing leasing capital allowances regime in place for all leases up to four years long and most up to six years long, so the impact will be substantially reduced and be detrimental only to large capital projects. So the current proposals will have a less widespread impact but we still believe that the OEF report raises important issues.

46. Our comments in relation to the points raised in paragraphs 4.52 to 4.62 are set out below. We have indicated the relevant paragraph number at the beginning of our own paragraph.

47. (Paragraph 4.52) Any definition of a funding lease is going to be arbitrary and is likely to produce unintended results at the margin. However, all but one of the criteria suggested appear to be broadly reasonable. The exception is the '50 per cent of expected remaining useful economic life' test, where practical issues will arise in determining with any certainty the real economic life of many types of asset. If this test is to remain, some very clear guidance (ideally incorporated into the statute) is required if this legislation is going to be capable of certain practical application. If part of the aim is simplicity, removal or clarification of this criterion is essential.

48. (Paragraph 4.53) A good approach to resolving the doubts as to the tax status of a lease, where there is reasonable uncertainty about one or more of the criteria in the definition, would be to allow the lease document to specify whether it was to be regarded as funding. This could be allowed where, for example, the present value of the rentals was between 65% and 85% of the market value of the asset, or the lease was for between 40% and 60% of remaining life. However, if certainty is to be achieved, each lease should have an established categorisation to be applied by both parties. Again, this could be required to be stated in the lease agreement if either party was to be able to claim capital allowances on the asset. Special rules would then be needed for leases with a UK lessee and a non-UK lessor.

49. (Paragraph 4.54) There is a degree of arbitrariness involved, but the suggested approach seems to give a broadly reasonable result, if one accepts the aim of the legislation.

50. (Paragraph 4.55) No major difficulty is foreseen in the practical application of the shorter leases rule. It may be better to apply percentage limits within which the lease rentals could vary in order to achieve certainty and to permit specific elements of a termination rental to fall outside this, as well as allow additional variations similar to those set out in section 100(5)(a) to (d) of the CAA 2001 but including exchange differences and other taxes (e.g. non-reclaimable VAT).

51. (Paragraph 4.55, further comment) Another alternative would be for Government to consider allowing taxpayers an elective right to transfer allowances to the lessee. This election would operate regardless of whether the transaction was caught by the new regime. Such an election could be used to achieve certainty in marginal cases and also to avoid further tax based market distortions.

52. (Paragraph 4.56) It would be much simpler (and probably give a fairer and more certain result) if an asset which had been leased already on a non-funding lease was dealt with as permanently subject to such leases provided that either (i) no later lease is for a longer period than the first lease, nor for a higher rental (subject to interest rate, etc., variations) or (ii) it met the basic criteria as if it was the first lease of the asset, but starting at the new date.

53. (Paragraph 4.57) The principles of the proposed reform would appear to be that tax should play no part in the decision on funding structures and that generally the economic owner should be able to claim capital allowances. This moves away from the long established ability within the UK taxing statutes that lessors can claim allowances and pass the benefit on to lessees where it was economically efficient to do so. This was particularly helpful where the lessee had no tax capacity so that the

timing benefit of accelerate tax depreciation was of no value to it. In turn, this was something that reduced the negative cash flow of inward investment projects and start-ups in general. Ultimately this is a policy question for the Government, but we think that it is important to review the wider implications of such a policy before it is introduced. The review should also consider, for example, the tax treatment of such transactions in other countries, in particular other EU member states, so as to ensure that the UK is not disadvantaged.

54. (Paragraph 4.58) If each lease specified whether or not it was categorised as funding, then with clear rules, it should be possible to ensure that no significant problems arose in chains of leases. It is unlikely that a double claim to allowances would be possible and the parties involved should be able to ensure that the situation did not arise in which nobody was entitled to allowances.

55. (Paragraph 4.59) We have no further comments in addition to those set out above.

56. (Paragraph 4.60) In order to give a greater degree of certainty, whilst a 'just and reasonable' basis is a good approach, it could perhaps be prima facie an amount set out in a joint election between the parties which could be overturned by the Inland Revenue only if the values departed from market value by at least, say, 20 per cent. In this way, a degree of estimation can be used without the need to involve independent valuers to make a division of proceeds that had no impact on the commercial transaction.

57. (Paragraph 4.61) The two key issues are the way in which existing leases would be grandfathered, including cut-off provisions and the categorisation of second and subsequent leases in respect of assets that had first been leased on a non-funding lease. It is suggested that for the first, it should be leases entered into before the specified commencement date (e.g. Royal Assent of Finance Act 2006), where the asset is made available for use by the lessee within six months of that (but with specific extensions for long construction period assets such as ships) and where the first lease rental was due no later than 12 months after the later of the lease is entered into or the asset is made available to the lessee. On the second issue, it is suggested that the first lease is looked at as if the new legislation had been in force at the time of its inception in order to consider the status of later leases.

58. (Paragraph 4.62) It would be helpful if all of the anti-avoidance provisions relating to leasing were brought together in a single, linked set of provisions, in order to give clarity and certainty to parties entering leases under the new regime. A number of the existing provisions would need modification to work as apparently intended under the new rules, so we recommend that the leasing provisions are completely rewritten in the Finance Act 2006.

IKY/FH
28 February 2005

APPENDIX 1

Responses to specific questions

Chapter 2 – Schedular reform

2.45 Draft core legislation has been published at Annex C, together with a technical commentary at Annex D and comments would be welcomed on the extent to which the approach currently adopted meets the aims of modernising the schedular system. The following questions seek to bring out some of the key issues.

We have set out below the specific questions raised in the Technical Note together with our responses. Other detailed comments on the draft statutory provisions in Annex C are set out immediately below.

We are disappointed with the overall approach that has been adopted to the drafting of the provisions set out in Annex C. We appreciate the difficulties faced by the draftsmen, but we would have preferred a more radical approach to drafting the new CT provisions e.g. as regards section 74. As it is, the process of amending the existing provisions and the continued use of the term Schedule D Case I looks anachronistic and arguably serves to confuse.

We believe that the new section 74, ICTA !988 should be drafted so that all genuine operating business expenses are relievable. We believe that dual purpose expenses should be apportioned between business and non business so that the business element of the dual expense can be relieved. At the moment the proposed relief is restricted solely to expenses where 'an identifiable part, or any proportion, of the expense is incurred wholly and exclusively' for business purposes.

In relation to new Clause 18A 6(4) – Requirement for expectation of profit or exercise of statutory functions we believe it would be fairer to carry out an apportionment rather than seeking to tax the company solely by reference to the way it carries on business at the end of an accounting period.

2.46 It would be helpful if companies could provide specific examples of the benefits (and how significant they are) that they would expect to derive from being able to pool trading and letting income (together with related Case VI items).

As we wrote in response to the 2003 Consultation Document (published as TAXREP 40/03), we believe that full pooling of schedules and cases would be considerably more straightforward than the current system. The current proposals are more modest, namely the pooling of just trading and letting income and certain miscellaneous income. We accept that this would provide some simplification benefits but the benefits of simplification are much more finely balanced than under the original proposals.

As we have noted in the main part of the response, see section headed *Regulatory burdens,* we believe that the time is ripe to undertake a research project into the regulatory burdens which business faces under the current system so that any proposed changes can take such burdens into account and try to ensure that the

replacement system keeps such burdens to a minimum commensurate with delivering the public policy objectives.

2.47 How effective is the "residual" approach - creating the new operating business source and then defining out those items, such as dividends, non-trading/letting loan relationships etc, which are not within its ambit?

The residual approach appears a reasonable one but, as noted above, we are disappointed with the overall result because the simplification benefits appear marginal. We are also disappointed with the overall approach that has been adopted to the drafting of the provisions set out in Annex C. We appreciate the difficulties faced by the draftsmen but we would have preferred a more radical approach to drafting the new CT provisions e.g. as regards section 74. As it is, the process of amending the existing provisions and the continued use of the term Schedule D Case I looks anachronistic and arguably serves to confuse.

2.48 The new operating source will include both trading and letting loan relationships. Do respondents envisage significant difficulties in separating these from loan relationships entered into for other purposes?

Whilst we accept this is an extension of the approach currently adopted in section 82(2) & (3), FA 1996, we suspect that some companies may have problems separating these out. We would be grateful for clarification as to the reason for the blanket exclusion of non-trading debits and credits from the total operating business source income.

2.49 Are there particular concerns about the impact on the availability of double taxation relief?

As we noted in our response to the 2003 Consultation Document it is already necessary to carry out an apportionment when part of the Schedule D Case 1 computation qualifies for double taxation relief and part does not. A 'fair and reasonable' apportionment should be applied under the new regime.

The Government issued a Technical Note on 2 December 2004 which included proposals to clarify the way that relief is given for foreign tax paid on trade receipts. We are extremely concerned that that consultation seems to have been ignored by Government in the light of the Special Commissioners decision in the case of *Legal & General Assurance Society Ltd v David Thomas (Inspector of Taxes)* SpC 463 and we wrote to the Paymaster General on 11 February 2005 to express these concerns. We subsequently published our letter as TAXREP 6/05 which can be accessed at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_77147

We are concerned that business should get appropriate relief for overseas tax that it suffers and we hope that the issues raised in the Technical Note will be satisfactorily resolved. We consider the 'Mini Case 1' approach advocated in the Technical Note to be wholly contrary to the ostensible purpose of CT reform. If further targeted legislation is needed beyond sections 798 to 798B, ICTA 1988 then this, in our view, is what should be done.

2.50 Is the proposed treatment of losses arising from the new source the most appropriate?

We broadly welcome the thrust of the proposals.

2.51 How should relief be given for pre-commencement losses, assuming it would not be possible to give immediate full relief for all such losses against future profits from the new operating business source? And should there be specific rules for smaller companies?

We have previously suggested, in the detailed comments above, that the third option set out in paragraph A.49 of the August 2003 Background Notes is the proposal which appears to us to have the most merit. This is that pre-commencement losses should be capable of being set against the same range of profits as post-commencement losses but only a certain proportion of pre-commencement losses could be used in any one year, with the balance having to be carried forward for use in later years.

However, as the current proposal of combining trading and letting income is much more modest, we consider that taxpayers should be able to carry forward their trading or rental business losses against total business operating income.

In answer to the second part of this question we do not believe that there should be specific rules on this issue in relation to smaller companies.

2.52 What issues will need to be addressed in the case of special regimes such as those mentioned in paragraph 2.34?

We suspect that these issues are best dealt with by establishing working parties with the relevant industry sector representative bodies to examine the issues in detail.

2.53 Given the increased flexibility how could the Government best protect itself against manipulation through loss buying and profit buying?

We understand the concern about manipulation and the need for the Government to protect itself. However, we believe that amendment of section 768, ICTA 1988 to reflect the operating business income approach ought to provide adequate protection. If Government does not share this view, we think that the issue should be dealt with by establishing a working party with the professional bodies and industry. We would also note that if innovative 'schemes' to manipulate the new provisions arise, then such schemes will probably require disclosure under the Disclosure of Tax Avoidance Schemes (DoTAS, Part 7 Finance Act 2004) and the Government will be able to take a view in relation to the particular arrangements as to whether it feels that they undermine the purpose of the 'new' loss provisions.

2.54 Are the current loss-buying rules regarded as providing sufficient protection for the Exchequer whilst providing certainty of outcome for business?

The existing loss-buying rules are well established. However, the key words 'a major change in the nature or conduct of a trade' are uncertain in scope and it has been left to the Courts to determine the precise meaning of these words. We do not consider

that the conclusions reached by the Courts and the Inland Revenue's views, as set out in Statement of Practice SP 10/91, are quite so relevant in the context of the proposed new regime covering 'operating businesses' and this aspect will need to be reviewed.

For example, suppose a company, mainly trading, makes substantial losses under the new regime and closes down its trading businesses and lets out the surplus property. Over time its income becomes almost exclusively rental income. We presume that it is going to be permissible for the accumulated losses to be set off against the rental income under the new regime? In the absence of a change in ownership we presume that the 'trading' losses will be fully relievable against the 'rental' income but would welcome clarification that this is the intended result.

We believe these issues need further consideration and clarification so as to reduce or eliminate the potential uncertainties.

Whatever proposals are finally adopted there will need to be consequential changes to the provisions in relation to capital allowances in the CAA 2001.

Life Companies

2.55 Do the proposals for life insurance companies seem appropriate and are there likely to be any practical difficulties?

We anticipate that our members involved in this area will be making detailed comments through the industry bodies such as the Association of British Insurers.

Abolition of charges

2.56 Is the abolition of charges (and their recasting as operating business expenses or life assurance business expenses) a useful proposal? Are there likely to be any practical difficulties?

We favour the abolition of charges on income. We do not believe that the term is recognised in jurisdictions other than the UK and Ireland and it does not appear to have a place in the modern UK business environment.

In response to the second part of the question we do not foresee any practical difficulties as a result of the abolition of charges.

Chapter 3 - Capital Assets

There is no specific question in relation to paragraph 3.29.

There is a discussion in that paragraph as to how to deal with the cost of the land on a disposal. If the 'cost of the land is to be introduced into the pool at the time of disposal' then this negates the potential benefit that pooling creates. The appropriate way to deal with the 'historic non-qualifying element on disposal' needs to be resolved and we would be very happy to consider this issue further with the Government.

3.48 What is companies' view (sic) of the broad approach set out at paragraphs 3.10 to 3.15 above?

As we noted in our detailed comments, the proposal to treat capital assets under an income regime would eliminate indexation relief which would be to the disadvantage of many businesses. The extension of buildings allowances to commercial buildings would broadly compensate most but not necessarily all taxpayers. Companies with significant investment property assets would however be particularly affected by the abolition of indexation. Any proposal also needs to consider the timing effect of lost rollover relief on cash flow.

3.49 What benefits do companies see arising from bringing the full amount of disposal proceeds on plant and machinery into charge through the capital allowances system?

We think this is a sensible simplification, subject to our comments below regarding the need for a grace period where proceeds exceed the pool.

3.50 Should a reformed capital allowances regime have special rules to defer profits on reinvestment (beyond the automatic deferral effect that would be achieved by pooling)?

As proposed in paragraph 3.23, we agree a 'grace period' e.g. three years would be appropriate where a pool is exhausted by the sale of an asset.

3.51 What special reliefs or computational provisions within the current capital gains regime would need to be adapted within a reformed capital allowances regime (for example in the case of transfers within a group)?

The existing roll-over relief provisions found in section 152 et seq, TCGA 1992 will need to be adapted. In addition an equivalent to section 171, perhaps modelled along the lines of the Intellectual Property (IP) group transfer provisions in FA 2002, would in our view be required.

3.52 What benefits does business see in the approach to buildings allowances suggested at paragraphs 3.27 to 3.35?

We believe that business will welcome the broad thrust of the approach to the proposed reform of the industrial buildings allowance code. However, on the assumption that the allowances available for a commercial building will be lower than that available for plant and machinery, the boundary between what qualifies as expenditure on 'a commercial building' and what qualifies as plant and machinery will still be important. The proposals set out in paragraph 3.32 of the document appear a reasonable attempt to identify the boundary. If it is decided to proceed with the proposal, we suggest that the issue is subject to a further more detailed consultation.

3.53 How should a building be defined for the purpose of any expanded buildings allowance?

In our response to the 2003 Consultation Document we recommended 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.

We remain of this view. Any decisions about changes to the taxation of commercial buildings could then be taken in the light of a better understanding of the contemporary nature of such buildings.

3.54 How could the transition to any new regime be handled?

Our preferred approach would be to keep existing expenditure under the current code and new expenditure under the new code. However, we recognise that this would result in a lengthy transitional period.

3.55 What are the implications for any reforms for the taxation of unincorporated businesses and for the interface between companies and the unincorporated?

We will be dealing with the interface between companies and the unincorporated in our response to the Discussion Paper on *Small companies, the self-employed and the tax system.*

We remain concerned that the tax regimes for incorporated and unincorporated businesses have diverged considerably in recent years, and we question whether in principle this is a desirable policy approach.

3.56 What are the views of business on the possible options for the reform of expensive cars?

See the detailed comments section above.

3.57 The Government would be interested in the views of business on the case and scope for change on abortive capital expenditure in the absence of a wider reform of the capital/revenue divide.

We consider that both options proposed (Paragraphs 3.46 and 3.47) should be pursued, so that abortive capital expenditure is relieved either as an allowable capital loss or via the capital allowance pool.

Chapter 4 – Leasing

4.52 Is the proposed definition of a funding lease appropriate? Are there any elements in the proposed definition of a funding lease that might cause difficulties in practice? Would there be different difficulties from the perspective of lessor and lessee? It would be helpful to have examples of existing leases where the difficulty would (or is likely to) have arisen.

Our detailed comments in relation to questions 4.52 to 4.62 are included in the main part of our response under *detailed comments.*

4.53 What are the advantages and disadvantages of allowing lessee and lessor to take an independent view on whether a lease is a long funding lease?

See response to 4.52 above.

4.54 Would the proposed definition of long funding leases, including the length of leases covered, fulfil its purpose of excluding leases where the tax treatment had no significant effect on the choice of method of finance?

See response to 4.52 above.

4.55 Would the exemption for shorter leases be easy to apply in practice? Which is the best way to define lease rentals as 'broadly the same' over the life of the lease (Annex A, paragraphs A.4 to A.6)

See response to 4.52 above.

4.56 Would the proposed rule concerning assets leased more than once achieve the objective? Is there a better way?

See response to 4.52 above.

4.57 The Government would welcome comments on the detailed proposals for taxing both lessors and lessees in the new regime, distinguishing, between issues that apply where the lease is accounted for as a finance lease or as an operating lease.

See response to 4.52 above.

4.58 What issues arise on chains of leases that would need to be addressed in the legislation?

See response to 4.52 above.

4.59 The Government would welcome views on the approach to changes of use as set out in Annex A.

See response to 4.52 above.

4.60 Would a "just and reasonable basis" be the best rule for apportioning income and costs when plant was leased with other assets under a single lease?

See response to 4.52 above.

4.61 What issues around the commencement of the new rules would need to be addressed? Specific examples would be very helpful.

See response to 4.52 above.

4.62 Apart from the overseas leasing and allocation rules (paragraphs 4.40 to 4.43), is there any other anti-avoidance legislation that could be amended or removed as a result of this reform?

See response to 4.52 above.

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.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160.