

TAXREP 3/10

SIMPLIFICATION REVIEW: THE ASSOCIATED COMPANY RULES AS THEY APPLY TO THE SMALL COMPANIES' RATE OF CORPORATION TAX

Memorandum submitted on 22 January 2010 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document published in October 2009 by HM Treasury and HM Revenue & Customs (HMRC)

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INTRODUCTION

1. We welcome the opportunity to comment on the Consultation Document published in October 2009 by HM Treasury at http://www.hm-treasury.gov.uk/consult_simplification_review.htm
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

SUMMARY

3. We are disappointed that once again we see brief legislation which is to be interpreted by HMRC guidance. Companies must self assess their liability to tax and we think that clarity is essential to achieve certainty.
4. It is completely unclear where the dividing lines will be drawn and some of the examples given as 'related' in the draft guidance do not fit the overall test that 'the links between the companies are sufficient to consider them interdependent and thus fragments of a wider whole'. Even relatively modest financial support, by way of guarantee or security, appears to make companies related.
5. The current guidance will leave enormous uncertainty about how the new provisions are going to be applied in practice and will allow individual HMRC personnel to be accommodating, or difficult, as they see fit.
6. If we are to be ruled by the 'spirit of the law' and 'the intention of Parliament' then we must be rather clearer about what that means in practice.

GENERAL POINTS

7. We welcome the proposed extension of the provision introduced in FA 2008. That (2008) provision was designed to prevent companies controlled by 'partners' automatically being treated as associated with other companies unless there are 'relevant tax planning arrangements' in place. The current proposal is to extend that provision to any associates and not just partners.
8. It is clear from the draft guidance (CTM03750) that these provisions are only intended to apply in limited circumstances and the overarching purpose of the legislation is to treat companies as associated only when 'the links between the companies are sufficient to consider them interdependent and thus fragments of a wider whole' (paragraph 3.6 of the Consultation Document).
9. The Consultation Document sets out what this is going to mean in practice by way of a number of examples in Annex C.

10. We are concerned that, as they are written, the examples do not give a terribly clear idea of what the new rules will in practice nor how they are likely to be applied to a different set of facts or circumstances.
11. In essence, the new proposals will treat companies as associated if they are controlled by associated persons and there are some financial, organisational or economic links between the companies.
12. What is meant by financial, organisational and economic links is spelt out in draft guidance paragraphs CTM03785, CTM03790 and CTM03795 respectively.
13. We are concerned that the current draft guidance does not indicate sufficiently clearly how the key factors are going to be applied in practice to treat some companies as associated and others as not associated.
14. We believe that the guidance needs to be much clearer about how the criteria are going to be applied in general terms, backed up by examples which are clearer than those currently drafted.
15. We also believe that HMRC should consider a clearance procedure so that there can be certainty about how the law will be applied to a particular set of circumstances.

COMMENTS ON THE DRAFT GUIDANCE

Financial links

16. It would appear that if there is any financial support by one company of the other then the two companies are going to be treated as associated. This seems clear from the first example involving companies D and E.
17. However, we note that they are not associated if, as in the example, there is a personal guarantee provided '*as a family matter and not for business reasons*'. It is not absolutely clear how a personal guarantee gets turned into a '*guarantee given for business reasons*'. The example suggests that if the individual '*had given additional security over the assets of company D in support of the loan to the company*' then this would constitute a financial link and the two companies in question would be associated. As a matter of law the individual is not in a position to give security over assets owned by the company, although if he is the major shareholder in the company he can use his influence to ensure that the company provides the required security.
18. It is difficult to see why if the individual provides the guarantee the companies are not associated but, on the same facts, if one company provides some security to the other the two companies are then treated as associated i.e. as if they were really a single company that has been fragmented.
19. The third example concerns a public house where the husband's company runs the 'wet trade' and his wife's company runs the catering. They are run in a financially independent manner, but it is stated that the companies '*share a common economic goal and premises*'. It is also stated that the catering company would not be viable without the wet trade company but it is not clear

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why that is the case. This will depend on the facts in a particular case and all pubs are different.

20. If the husband's company sold the wet trade business to a completely independent business which charged market rates for all the facilities used by the catering business that is exactly the same financial arrangement as at present. The catering business would be just as financially viable then as it is now. Also what is meant by the two businesses '*share a common economic goal*'? Does that mean more than that they are both in business to make a profit? Clearly both businesses share the same premises. It is not clear what are considered to be the critical factors that have led HMRC to conclude that the two companies are associated.

Economic links

21. In the third example in this section about companies C and D it is stated that they were trading well before the two owners got to know each other and married. Would the analysis be the same if Mrs Q started her restaurant business when her children went to university and were no longer dependent on her on a day to day basis?
22. In the final example in this section involving companies S and R it is not clear to us what HMRC considers to be the vital link between the two businesses which causes them to be treated as associated. Company R is stated to act as the 'agent' for the specialist wedding and evening dresses business carried out by Company S. We are not clear what being the agent means in this context. Does Company R act as if it also has a specialist business of this nature and in practice passes on the garments to Company S to be dry cleaned? If Company R took on all types of dry cleaning, but in practice passed wedding and evening dresses to Company S without advertising the fact, would the two companies still be treated as associated? Would it make any difference if the amount of business that Company R passes to Company S is only a very small part of the business of either company?

Organisational links

23. In the second example in this section the existing company gives security over its own assets to support a bank loan to the new company set up by the wife. This is said to create an organisational as well as a financial link between the two companies. We can see that there is a financial link but why is this described as also being an organisational link? The opening to this section of the draft guidance suggests that organisational links could be common management, employees, premises or equipment. None of those apply in this particular example.

SPECIFIC QUESTIONS

Do you feel that the proposed new test ensures that companies would only be associated when their level of interdependence means that it would be appropriate to do so?

24. What the new test means in practice is to be demonstrated by the draft guidance. But we are very concerned that as currently drafted, the guidance

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does not give sufficient clarity about how the new rules have been interpreted even in relation to the facts in the examples given. Even less so do they provide any coherent guidance about how the test would be applied to a different set of facts or circumstances.

25. We also feel that some of the guidance should indicate where, in the particular circumstances, a dividing line would be drawn. So for instance in relation to the dry cleaning businesses discussed in paragraph 17 above, is there some de minimis level of business for work passed between them below which they would not be treated as associated?

If not, what aspects of the proposed new test should be amended?

26. There needs to be much greater clarity in the examples as to how the tests are applied in practice.

Are there any areas that you feel the draft guidance does not cover and would benefit from further examples?

27. It would be helpful to have further examples involving shared premises. With more people working from home, and the UK becoming more of a knowledge economy, there will be instances, for example, where husband and wife, or partners, carry on their businesses from their home. They might well share a common internet connection with separate monitors etc but what would cause them to be treated as associated, or treated as not associated?
28. Family businesses that are set up by one generation may well be split into separate businesses when passing into the ownership of the next generation. In such circumstances what was once a single business will be split into several separate parts. Presumably that would not be treated automatically as a fragmentation to be caught by the new section 13 provisions. But it would be helpful to know what sort of separation would be necessary for the new provisions not to apply.

Do you have any views on the Impact Assessment in Annex D?

29. We do not have any comments on the Impact Assessment.

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
2. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
3. 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 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

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 www.icaew.co.uk/index.cfm?route=128518.