TAXREP 14/12

(ICAEW REP 34/12)

ICAEW TAX REPRESENTATION

FINANCE BILL 2012
Comments on the draft clauses published in December 2011

Comments submitted by ICAEW Tax Faculty in relation to the draft clauses for inclusion in Finance Bill 2012 published on 6 December 2011.
The detailed comments were submitted prior to the deadline of 10 February 2012 and published as TAXREP 70/11 andTAXREPs 3 – 11/12. Further comments on CFC reform published in TAXREP 13/12.
The current document contains the comments in all those earlier submissions and was submitted on 1 March 2012 to the Exchequer Secretary at HM Treasury and the Permanent Secretary for Tax at HM Revenue & Customs (HMRC)

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FINANCE BILL 2012

INTRODUCTION

1. The present document reproduces all the Tax Faculty comments on the draft Finance Bill 2012 clauses published for comment on 6 December 2011. Our comments were contained in TAXREP 70/11 and TAXREPs 3 – 11/12 submitted to the relevant government policy officials before the deadline of 10 February 2012. TAXREP 13/12 with comments on the additional clauses on CFC Reform published on 31 January 2012 was submitted on 24 February.

2. We welcome the Government's commitment to provide greater time for scrutiny of draft tax legislation following a period of prior consultation.

3. The provisions will be published by the government on 29 March 2012, after appropriate amendment, as part of Finance Bill 2012.

4. The Budget will take place on 21 March 2012 in advance of publication of Finance Bill 2012. In the Budget we understand that the Chancellor will set out the taxation measures on which the government will be consulting over the coming months prior to publication of draft clauses in December 2012 for inclusion in Finance Bill 2013.

5. Our Ten Tenets for a Better Tax System which we use as a benchmark to evaluate tax legislation and the tax system are summarised in Appendix 1.

WHO WE ARE

6. The Institute of Chartered Accountants in England and Wales (ICAEW) 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, ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

7. 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.

8. The Tax Faculty is the focus for tax within ICAEW. 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, and a free weekly newswire.

GENERAL COMMENTS

9. In this section we summarise the key points made in this paper and highlight our major comments on the measures contained in the draft clauses for inclusion in Finance Bill 2012.

REFORM OF THE TAXATION OF NON-DOMICILED INDIVIDUALS

10. We welcome the opportunity to comment on the draft legislation. We are disappointed, however, that the additional draft legislation that was promised for early 2012 remains unavailable and is unlikely to be available before the publication of Finance Bill 2012. [Since we submitted TAXREP 3/12 in respect of these provisions we have received draft clauses re part disposals and the funding of CGT but, at the time of preparing the current TAXREP, we are still awaiting the draft clauses on gains on the disposal of an exempt asset to be treated as a foreign chargeable gain.]

11. In connection with the draft legislation our key points are:
    - a qualifying investment should include investment in a partnership, including an LLP;
    - a taxable remittance will arise if the investment is in a close company which is a relevant person in connection with the investor when the company makes use of the funds;
    - a qualifying investment should include the purchase of share/securities from a third party;
    - clarity is required on the definition of an 'eligible trading company' as regards those holding residential property;
    - the definition of 'substantial' for the purposes of determining whether a company is an eligible trading company should be in the legislation not in guidance;
    - minority shareholders will have particular problems in determining whether a company has breached the 'substantial' test when looking at the whole of its trading activities; this test should be replaced by a 'wholly or mainly' test;
    - consideration needs to be given to the interaction of these provisions with s 127, TCGA 1992 when a qualifying investment is acquired in a share for share exchange with a foreign company;
    - the definitions of 'eligible trading company' and 'eligible stakeholder company' are too simplistic and do not cater adequately for more complicated group structures;
    - there needs to be a grace period to permit the export of money when a prospective investment falls through;
    - the 45 day grace period for removing sale proceeds from the UK needs to be extended where the potentially chargeable event is a listing of the target company;
    - ceasing to be a relevant person should not be a potentially chargeable event;
    - an individual should be allowed to take property equivalent to the value of the proceeds offshore to satisfy the appropriate mitigation steps;
    - provision needs to be made where sale proceeds need to be brought back to the UK to satisfy warranties under the sale contract;
    - in connection with the sale of exempt property, the 95 day time limit is too short and this condition should be removed. The grace period should start with the day that the sales proceeds are freely available to the seller; and
    - the proposed simplification of the nominated income rules should allow an election, with a four year time limit, to amend previous elections.

Further general comments on the proposed reform of the taxation of non-domiciled individuals

12. We welcome the majority of the measures that are included in the draft legislation and are pleased to see that a number of the comments that we made in TAXREP 49/11 on the document *Reform of the taxation of non-domiciled individuals: a consultation* have been taken into account. Our detailed comments on the draft legislation are set out below.

13. We have one overriding general concern on the availability of the relief. It appears to us that, as the draft legislation stands, the benefit the relief provides is undermined where the investment is in a close company and the taxpayer, or any other relevant person, is (or as a result of the investment becomes) a participant in the company. The problem is that the company will then be a relevant person in connection with the taxpayer (s 809M, ITA 2007). The relief can be claimed on the initial investment but there is nothing to disapply s 809L, ITA 2007 when the company uses the funds in the UK and this will be a taxable remittance. We assume that this is not the intention and suggest the legislation is amended so that s 809L, ITA 2007 cannot apply in the circumstances outlined. This could be achieved by adding a sub-section to the new s 809VA. The new sub-section would state that where a qualifying investment is made the target company will not be treated as a relevant person in connection with the taxpayer when considering the application of s 809L, ITA 2007 in connection with transactions directly or indirectly related to the funds used to make the qualifying investment.

14. In connection with the remittance for investment purposes, we remain of the view that investment in a partnership, and particularly LLPs, should be a qualifying investment. We believe that including partnerships would lead to significant additional investment into the UK. We understand that consideration is now being given to including investment in such structures. We are happy to work with the Government to develop legislation in this regard with a view to including it in Finance Bill 2013.

15. We believe that there is still some uncertainty over the question of whether an investment in a company holding residential property, or property with a mixed use, will qualify. We refer you to our comments at paras 20 and 21 below.

16. We set out in TAXREP 49/11, at paras 23-25, our concerns that the proposals may not be compliant with European law and in particular the provisions on State Aid. We are aware that the Government has taken advice on this matter and would again ask that this advice be published to allay any uncertainty.

17. We await the draft legislation to treat the capital gain on the sale of an exempt asset as a foreign chargeable gain which will be subject to the remittance basis of taxation. We are concerned, however, that linking the relief to the exempt asset provisions could disadvantage those individuals who bring assets purchased out of 'clean' capital to the UK for sale, where any capital gain would remain chargeable. This could be a particular problem where the assets are part of a set. We suggest that for these purposes the assets which can qualify should include assets which would fall into the category of exempt assets if they had been acquired remittance basis income and gains.

18. In connection with the simplification measures we are disappointed that our proposal to increase the £2,000 de minimis limit for unremitted foreign income or gains to the level of the personal allowance has been rejected. We consider that the limit is too low to deal even with relatively simple cases. The calculations are administratively costly and, we suspect, there is widespread non-compliance.

GIFTS OF PRE-EMINENT OBJECTS

19. We welcome the opportunity to comment on the draft legislation, although we are disappointed that we did not have the opportunity to discuss our concerns before submitting this TAXREP.

20. In connection with the draft legislation our key concerns are:
- the scheme should be extended to allow donations by trustees and personal representatives;

- a tax reduction should be available where an object is donated which is held under a bare trust arrangement;
- there is no definition of what constitutes an individual's liability to income tax; and
- the allocation of the tax reduction should be capable of revision by the donor.

Further general comments re Gifts of pre-eminent objects

21. We welcome the changes that have been made to the original scheme following the consultation last summer. In particular we welcome the increased annual limit, the extension of the scheme to corporate donors, the increase of the tax reduction to 30% and the removal of a charge to Inheritance Tax or Estate Duty which has previously been deferred.

22. We also welcome the provisions enabling an individual donor to spread the tax reduction over a five year period. We are concerned, however, that the requirement to specify in the agreed terms the allocation of the tax reduction is inequitable and may undermine the attractiveness of the scheme.

23. We are disappointed that the scheme does not permit donations from trustees and personal representatives. There are a large number of objects held in trusts and the decision not to extend the scheme to these potential donors will reduce the pool of available objects.

INHERITANCE TAX: GIFTS TO CHARITIES ETC

24. We are disappointed that the legislation is not based on the alternative regime that we proposed in our response TAXREP 47/11 (see via http://www.ion.icaew.com/TaxFaculty/22879) to HMRC's June 2011 consultation document. In that we suggested that IHT at 40% should be reduced by a 'tax credit' of 3.6% of the gross chargeable estate, ie the estate before deducting the charitable legacy but after deducting the nil rate band. Our suggestion would be relatively more generous to the residuary legatee where charitable etc legacies are greater than the minimum 10%, thereby providing a greater incentive to make such legacies. In our opinion, this would better meet the Government's objective of encouraging gifts to charity.

PAYE REGULATIONS: INFORMATION (REAL TIME INFORMATION)

25. We have no specific comments on this legislation which is designed to facilitate the operation of Real Time Information RTI (RTI) by allowing HMRC to make regulations to require that RTI reports are cross referenced to actual payments. The proposal currently as we understand it is that where employers/payroll bureaux initiate payments of earnings to employees by BACS (known as direct BACS), the payroll software will generate a unique reference number for each payment which will be included in the BACS file and reproduced on the RTI report submitted to HMRC. This is intended to enable HMRC to link and check the information in the RTI report to payments actually made. One of the objectives of RTI is to help protect the exchequer by tightening up on employer compliance, which if undertaken in a proportionate manner should benefit the nation as a whole.

26. However, we do have a number of concerns about RTI itself. These concerns, which are typical of the sort of problems that the PAYE system needs to deal with, are coming out of the current discussions with HMRC (for example how should leavers be treated, the decision for which was announced only on 6 February – see nds.coi.gov.uk/clientmicrosite/Content/Detail.aspx?ClientId=257&NewsAreaId=2&ReleaseID=423160&SubjectId=36). Given that the pilots begin in less than two months (April

2012) and mandation of employers starts from April 2013, we have serious doubts about whether the timetable for implementation is realistic.

27. The employer tax system works because local HMRC staff have in the past accepted 'local agreements' with employers and/or the process has been sufficiently flexible to accommodate workarounds. As RTI will be a computerised process, it will be difficult to accommodate such workarounds. We are assisting HMRC to help ensure RTI will work for HMRC, employers, employees and third parties such as agents and payroll bureaux. As well has being part of HMRC's Customer User Group we have, just in the last two months, met or have arranged to meet HMRC to discuss, inter alia, the submission channels, leavers, agents (in particular payroll-only agents), small employers, expatriates, pensioners, education and communication, etc. The extensive informal consultation undertaken by HMRC is welcome, although it has highlighted the size of the task to have RTI fit for purpose by when it is made mandatory.

28. Many of our concerns are included in our response to the invitation to comment on draft secondary RTI legislation TAXREP 01/12 (accessible via www.ion.icaew.com/TaxFaculty/23813) which includes the text of our written submission in November 2011 to the Public Accounts Committee. We hope that all or most of our concerns will be resolved while the 2012 Finance Bill progresses through its Parliamentary stages but where they have not been addressed then we shall raise them as part of this process.

29. We acknowledge that the RTI penalty regime will be included in Finance Act 2013 and be subject to consultation but we should like, even at this stage, to express our concern about penalties. In common with other employer obligations, the submission of accurate RTI reports on time is likely to be underpinned by an automatic penalty regime. As evidenced by many Tribunal judgements, non- or late-filing penalties are issued automatically even where the relevant return has been filed on time. The time, effort and costs of reversing such penalties can be considerable. Should HMRC's systems incorrectly report that a duly submitted RTI report has not been submitted (eg where BACS data is unable to be matched with the associated RTI report to which it has been cross-referenced), then an automatic penalty is likely to be issued which will not be due. This will mean that the employer/bureau or agent will have to spend time in getting the penalty cancelled.

30. We do believe that it is vital to get the RTI rules and processes right first time and that penalties should only be applied once HMRC can demonstrate that its RTI systems are working correctly.

PATENT BOX: CORPORATION TAX REFORM

31. We commented in TAXREP 41/11 on the earlier consultation document published jointly by HM Treasury and HM Revenue and Customs in June 2011.

32. In our earlier paper we stated that:

> 'We welcome the commitment to introduce a patent box regime from 2013. We also welcome the fact that it is additional to the R&D tax credits regime. While R&D tax credits have the benefit of encouraging R&D to be carried out in the UK the patent box encourages exploitation of that R&D in the UK.
>
> As we noted in our earlier submission some of our members would have preferred a more extensive regime to encompass all types of IP but we believe that the current proposal represents a good initial approach and we would recommend that a review

should be carried out after say 3 years to determine how successful the new regime has been and what changes might further improve it.'

Patent Box: Service Companies

33. As currently drafted the legislation lacks incentives for companies which use technology to provide services as compared to those companies which produce products. We recommend that the government takes steps to ensure that this sector of the economy can also benefit from the new regime particularly in the light of the increasingly important role which the service sector plays in the UK economy.

Patent Box: General comments

34. We welcome the general thrust of the current proposals which reflect the objectives set out in the summer and should encourage the development of IP in the UK.

35. If the proposals prove successful then we hope that they will be extended to other forms of IP.

36. We note that Luxembourg has already extended its domestic legislation and Malta is in the process of extending theirs.

37. Depending on the outcome of the R&D consultation as to whether R&D expenditure should be recognised 'above the line' we would recommend that similar above the line recognition should also be considered for the Patent Box regime.

CONTROLLED FOREIGN COMPANIES (CFC) REFORM
The Gateway test

38. The key to the new CFC reform is going to be the Gateway test and because of its importance we submitted our initial comments on the Gateway test in a separate paper, TAXREP 70/11, submitted in December 2011 before our detailed submission, TAXREP 8/12, in February 2012.

    Our overall comments on the Gateway test were:

39. We welcome the Government's positive approach to the most recent consultation over the course of the past summer/autumn and in particular its agreement to design a 'Cadbury' based "Gateway" exemption to eliminate the majority of UK controlled foreign subsidiaries from the new CFC regime.

40. We do not believe the current drafting or structure of the legislation will achieve that objective, nor will it make the new legislation easy to operate and it is almost certain to result in undue bureaucracy and significantly increased compliance costs, unless modified.

41. Our detailed comments on the Gateway test and on the other CFC Reform provisions are set out in the detailed comments section below.

NEW SEED ENTERPRISE INVESTMENT SCHEMES (SEIS) AND CHANGES TO EIS AND VCT SCHEME RULES

42. We believe that further funding support for start-up and early stage businesses is needed since a shortage of easily accessible funding is a hindrance to growth.

43. Tax relief for those investing in new businesses is one way to achieve this. The nature of these businesses makes them a more risky investment prospect and this often leads investors to ask for a greater return from the capital they invest. A tax subsidy increases

this rate of return and will be enhanced through using the new Seed Enterprise Investment Scheme (SEIS).

44. When we met with HMRC in January 2012, we were told there is no further information on when EU approval will be given for the proposed increases to the company size and investment limits. The employee limit will increase from 50 to 250; gross assets will increase from £7m before/£8m after to £15m before/£16m after; the annual amount of investment that a company may receive under EIS and VCT rules will increase from £2m to £10m.

45. The rules will apply to investee company shares issued after 5 April 2012 and members have told us they have deals lined up ready to proceed. This delay is harmful to UK businesses.

EIS/VCTs and disqualifying arrangements

46. The proposed draft ss 299A and 178A and para 11A Sch 5B TCGA 1992 are too broad and not workable in their current form. The draft proposals would make it impossible to put any existing business in share form. The majority of venture capital trust (VCT) investments are in conjunction with management buy outs (MBOs) and Management Buy Ins (MBIs) and this proposed section will eliminate those transactions.

47. The response document states that this is a clear change of policy, but this change, certainly for VCTs will reduce the effectiveness of the relief. The proposed legislation should be focused more clearly to address EU concerns regarding state aid so as not to exclude transactions that do not breach the EU state aid guidelines.

48. The three capital types which appear to be in point are venture capital, risk capital and expansion capital. Venture capital specifically excludes buy-outs. However, risk and expansion capital while including venture capital do not specifically exclude buy-outs. In our view, there should be a way where the type of transactions which typically benefit from VCT investment can still be carried out with appropriate tax relief. This could, for example, use some form of quasi-equity arrangement. We would like to know if the UK Treasury has received specific guidance from the EU on the form the VCT relief could take without breaching the guidelines?

Seed Enterprise Investment Scheme

49. In July 2011, HM Treasury published its consultation, Tax-advantaged venture capital schemes: a consultation, in which it set out proposals for a new Business Angel Seed Investment Scheme (BASIS). We recommended that rather than developing BASIS as a new standalone scheme, a better approach would be to incorporate the support for seed investment by special provisions within the existing EIS. We hoped this would mean
    - less new legislation;
    - easier and cheaper administration; and
    - building on existing familiarity

50. While we are pleased that the proposals for the Seed Enterprise Investment Scheme (SEIS) use this approach, we are disappointed that the draft clauses run to 47 pages, much of which are just copied from the EIS legislation and is almost incomprehensible to all but the specialist adviser.

51. There will indeed be many businesses which will be able to raise funds using the SEIS and then go on to raise further funds under the EIS. For these businesses, the SEIS rules being as complex as the EIS rules will not add to the burden of legislation. However, for those small businesses which are not going to raise further funding, often

those which might not have been able to attract funding with EIS levels of relief alone, keeping within the very considerable list of rules will be a problem.

52. We understand the need to prevent avoidance, but feel this fails to reflect the needs of the customer user group. These businesses will be at a vulnerable stage in their development and the rules for the SEIS should be simple, certain and easy to claim.

53. Our members' experiences of the current EIS, where start-up companies have tried to implement their own schemes, is that too frequently they inadvertently do something to invalidate the relief –see appendix 2. The new SEIS is aimed at companies which probably have even less experience of the tax system and dealing with complex tax reliefs.

54. We fear that the cost of professional advice needed to implement any SEIS will be disproportionate to the amount of money which can be raised under these schemes. This is attributable to complex legislation rather than excessive charging.

55. It is difficult to see how a new relief which is arguably even more complex than the existing EIS, is going to help these start-up companies. In our view there is unlikely to be a high take up of the new SEIS in its current form.

56. The expression in new s 257 HC (4), ITA 2007, 'genuine new venture' is very difficult to define. Considerable guidance will be needed on this.

57. The policy objective of the SEIS is to help '…smaller, riskier, early stage UK companies, which may face barriers in raising external finance, to attract investment, making it easier for the companies to be established and to grow.'

58. The relief is not available where an investor wishes to invest in a small unincorporated business which has already begun to prove its business model by making early sales. Setting up a company before starting to trade is unduly onerous and does not make good business sense for young entrepreneurs who usually have little or no business advice, yet that is what these rules require.

59. We accept that EIS relief is available, but do not see why the more generous SEIS should not also be given to these very risky start ups when they incorporate. Perhaps restricting the relief in such cases to unconnected parties might be a way forward?

Advance assurance

60. It is important that businesses and investors know with certainty whether an investment will qualify for tax relief.

61. Where a business is likely to need substantial funds, we envisage SEIS funding will be raised for an initial £150,000, but with a commitment at the same time for follow on EIS investment, after the necessary amount (70%) of first round funding has been spent, together with any other commercial requirements achieved. It would not make commercial sense for a business to only start looking for the next funding round after the 70% of SEIS money has been spent.

62. Accordingly, we envisage one advance assurance application being made to cover both SEIS and EIS investment.

TAXPAYER'S AGENTS: DISHONEST CONDUCT

63. We welcome the consultation process on these provisions. HMRC are to be congratulated for having taken on board so many of the concerns expressed by us and

others. We have contributed to this consultation since it first started in 2009 and most recently we responded to the draft legislation published on 14 July 2011 (which was published as TAXREP 53/11).

64. We also welcome the publication on 6 December 2011 of HMRC's response to the July 2011 consultation which has helped to clarify a number of our concerns. Subject to the points below, we believe that the draft legislation should now work and is much better targeted and proportionate than earlier drafts. We look forward to participating in the consultation on the proposed guidance on these rules as set out in Chapter 3 of the response document.

65. As a professional body with a public interest remit to promote high standards amongst our members, we support HMRC's aim of tackling dishonesty, wherever it arises in the tax system. We should want to know if any of our members come within these provisions so that we can consider what action to take and we trust that HMRC will notify our professional conduct department in appropriate cases. We reiterate our previous comment that if the reporting gateway in s 20, Revenue & Customs Management Act 2005 does not provide the necessary powers for HMRC to do this, then that provision needs to be amended so that works as intended.

66. In order to retain the support of the tax profession, it is essential that these provisions are only invoked against agents who are clearly dishonest and not threatened against honest agents who make mistakes. Clearly mistakes and poor work standards need to be addressed but there is a danger that HMRC staff on the ground might seek to use these provisions routinely in inappropriate cases.

67. We therefore welcome the clear rights of appeal which should help to minimise any risk that these provisions might be used inappropriately. Further, we welcome confirmation in para 2.9 of the response document that HMRC considers that the enhanced safeguards will ensure that the legislation is targeted only at those agents where HMRC has evidence that they have acted dishonestly (our emphasis). The need for HMRC staff to have evidence of dishonesty is crucial to the success of these provisions and this point needs to be emphasised in any guidance and in HMRC's internal manuals.

68. We also welcome the statement in the notes accompanying the draft provisions that the measure will be kept under review and will be considered by the Implementation Oversight Forum.

INFORMATION POWERS

69. We are pleased to note that of the proposed methods of amending Sch 36, FA 2008, HMRC has adopted the method which makes relatively limited changes to the Sch 36 powers. However, we are concerned that the drafting of new para 5A(7) is far too wide, and that the appeal rights are too limited. We also make recommendations on safeguards which should be included in HMRC guidance.

DETAILED COMMENTS ON THE DRAFT FINANCE BILL CLAUSES

REFORM OF THE TAXATION OF NON-DOMICILED INDIVIDUALS

Schedule 1 Part 1 Increased remittance basis charge

70. We welcome the proposed adjustments to s 809V, ITA 2007 to permit the payment of the £50,000 remittance basis charge from remittance basis income or gains without incurring a tax charge.

71. We also welcome the confirmation, at para 2.128 of the summary of responses to consultation, that consideration will be given to removing the charge to tax on inadvertent remittances, that are not within the principle established in *Duke of Roxburghe's Executors v CIR* 20 TC 711, with a view to implementing any changes in Finance Bill 2013.

Schedule 1 Part 2 Remittance for investment purposes

72. Section 809VB(1)(a) requires that any investment in share/securities must be made by way of a subscription or the introduction of new capital rather than a purchase from a third party. We think this may cause problems where additional investment is required but it is first necessary to buy out existing shareholders. As a minimum we would suggest that this restriction is eased to permit arm's length third-party sales where the investor is acquiring a stake of 20% or more in the company. We understand from our meeting that consideration will be given to amending this section.

73. We appreciate that the draft legislation has broadened the original consultation proposals but we remain concerned that there remains uncertainty as to whether a company holding residential property will be an 'eligible trading company'. We understand the intention is that a company developing residential properties would qualify but not one that let such property, unless that activity formed less than a 'substantial' part, which we understand is to be less than 20%, of the company's total business activities. Section 809VC(5)(b) will be amended to reflect this.

74. The definition of 'substantial should be included in the legislation not relegated to guidance. It should take account of companies holding properties where there is mixed commercial and residential use. The legislation should also set out clearly the period for which the 'substantial' test needs to be satisfied.

75. It is not clear what the situation is when a share for share exchange is undertaken (which meets the requirements of s 127, TCGA 1992) and shares in a qualifying UK company are acquired by a non UK domiciliary swapping shares in their foreign company, such shares having been acquired using remittance basis income/gains, for shares in the UK qualifying company. We understand that it was not the intention that only a cash investment would qualify. We also understand that further consideration will be given to the situation outlined above as, while there would not be a remittance when the shares in the UK qualifying company are acquired, there would be a remittance when the UK shares, received as result of the exchange, are sold. The provisions of s 809VG, the grace period, would not apply to allow the withdrawal of the remitted income or gains or reinvestment within the 45 day period.

76. We find the definitions of 'eligible trading company' and 'eligible stakeholder company' to be too simplistic and potentially denying relief in the case of more complicated group structures. For example, it appears that relief would not be available where an investment is made in the holding company of a UK trading group, as this would fall outside the definition at s 809VC(1)(a) as extended by s 809VC(2). It seems to us in this situation that, in order to qualify, the investment would have to made in the trading subsidiary, which may be unattractive to an investor whose position is far less secure than if they had invested in the holding company. The legislation needs to take into account the fact that it is now comparatively unusual for modern trading companies of any size to operate as single trading companies. We recognise that a balance needs to be struck between the legislation achieving the underlying policy purpose and simplicity. We therefore suggest that the Entrepreneurs' Relief provisions could be adapted to

ensure that investment in UK trading groups can be undertaken for the purposes of this relief.

77. We note from our meeting that s 809VA(4) is to be amended. As it stands it would deny relief where there is an investment in specie and the property has previously qualified as ‘exempt’ under the existing provisions. We understand that the intention of the draft legislation was to prevent the temporary importation rule (s 809Z4, ITA 2007) having effect so as to extend the allowable investment period by 275 days. As currently drafted it goes further than this and thus requires amendment.

78. Section 809VA(5) requires an investment to be made within the period of 45 days beginning with the day on which the money or other property is brought to or received in the UK. There will be occasions when a prospective investment falls through and in this situation when money etc has already been brought to the UK there would appear to be a remittance as no ‘relevant event’ under s 809VA(1)(a) has occurred. We would ask that consideration be given to allow the prospective investor in this situation to remove the monies from the UK within a specified period so as not to incur a remittance basis tax charge.

79. The interaction between s 809VA(5) and s 809VB(7) needs to be clarified. Where a loan is made to a company, and can be drawn down over time, s 809VB(7) specifies that the loan is treated as being made when the first amount is drawn down. If this is read back to s 809VA(5) it would appear that the balance remaining undrawn after 45 days will also qualify for relief. We understand that this is not the intention and the draft legislation will be amended.

80. We question the need for s 809VA(6) which disallows the relief where the investment is made ‘as a part of or as a result of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance of tax’. The provision introduces considerable uncertainty – not least because a literal interpretation of it would make the legislation inoperable. We do not see what avoidance a purposive interpretation would catch that the other provisions in the legislation do not. We hope that, should a General Anti-Avoidance Rule be enacted, clauses such as s 809VA(6) will no longer be required. The provision should either be removed or its impact clarified so that it is properly targeted.

81. Section 809VC(2) defines an ‘eligible trading company’. This provides, inter alia, that such a company is one that carries on commercial trades, or does so as a substantial part of what it does. This condition is a particular problem for minority shareholders who will often not be in a position to judge if the test is breached and a tax charge is triggered by the company changing the way it undertakes its trading operations. We suggest that the ‘wholly or mainly’ test used in the Inheritance Tax legislation for Business Property Relief (s 105(4), IHTA 1984) would operate in a fairer manner; this is because it should be more apparent to a minority shareholder that there has been a fundamental change in a company’s business activities which might breach the test. We understand that this suggestion will be given due consideration and we welcome this.

82. We appreciate that it is intended that the 45 day grace period will only run from ‘the day on which a relevant person became aware or ought reasonably to have become aware of the potentially chargeable event’ (s 809VG(10)(c)). However, this still leaves open the prospect of disputes where HMRC suggest that the investor should have known even where they did not. Our suggestion at para 28 above would help to avoid such disputes and reassure investors, particularly those with a minority shareholding. We understand that consideration is already being given to extending the 45 day rule where the changes

in the way a company undertakes its trading operations are outside the control of the investor.

83. Section 809VC(7) provides that the carrying on of research and development (R&D) will in certain circumstances be treated as the carrying on of a commercial trade. An individual investing in such a company may therefore benefit from the proposed relief. We are concerned, however, that if a UK based R&D company is set up to service an offshore group and invoices for those services (which it would have to do to help ensure that it does not run into any transfer pricing issues), there may be a remittance problem when those invoices are paid. The monies used to settle the invoices may be traced back to remittance basis income/gains of a UK resident foreign domicile. We suggest that in such cases the relief is extended to the payment for the R&D work. Without this extension we think that the attractiveness of the scheme for investment in R&D companies will be undermined.

84. An investment in a limited liability partnership is not a qualifying investment under s 809VB by virtue of s 809VC(4)(b). It seems to us, however, that an investment in a private limited company which is itself a partner in a limited liability partnership could be a qualifying investment.

85. In s 809VD, which sets out Condition B for an investment to count as a 'qualifying investment', we consider that there should be a test to exclude any related benefit received that is charged to income tax, as for the extraction of value rule at s 809VF(3).

86. We understand the decision not to extend the relief to an investment in a company quoted on a recognised stock exchange. We do not understand, however, why a listing of a company should constitute a 'potentially chargeable event' under s 809VF. This provision forces an investor to dispose of the investment, within the 45 day grace period, to avoid a tax charge on the monies originally invested. It will not be beneficial to any company to have tax legislation that incentivises investors to dispose of their investment so close to the date of floatation. In many cases it will be impossible to make such a disposal as there is frequently a 'lock in' of capital when a company is floated. If the listing of a company is to remain a 'potentially chargeable event' then consideration needs to be given to significantly extending the 45 day grace period, we suggest that three years is appropriate in this situation.

87. We are unclear about the operation of s 809VE, which sets out the circumstances in which income and gains are treated as remitted to the UK, and s 809VF which defines a 'potentially chargeable event' for the purposes of s 809VE(1). There appears to us to be some ambiguity over who 'P' is in the two sections. It appears from the draft legislation that P is the investor, however, P may not be the taxpayer to whom the original remittance basis income or gains arose, that individual may be a relevant person under s 809M, ITA 2007. In this situation we assume that the tax charge where there is a potentially chargeable event and no mitigating action is taken falls on the relevant person rather than P.

88. In addition, at s 809VF(2)(a) the words 'for the benefit of P or another relevant person' are too vague. It needs to be made clear that one considers relevant persons in connection with the individual to whom the original remittance basis income or gains arose and not in relation to P.

89. For a number of reasons we do not consider that the relevant person who made the investment ceasing to be the relevant person should be a potentially chargeable event under s 809VF(1)(b). First, it could discourage the UK investment of gifted funds on behalf of minor children or grandchildren. Second, a tax charge could arise on a divorce.

As the legislation provides for a potential tax charge on the disposal of the investment this appears to be the appropriate time for any tax charge to arise. There is also concern that the death of the investor would trigger a tax charge. We think this is inappropriate.

90. We suggest that a provision be inserted to defer a chargeable event where transactions occur between relevant persons. As currently drafted, we think that a tax charge would arise on the transfer of a qualifying investment to a spouse or civil partner.

91. Section 809VF(6) defines the two-year start-up rule which applies to an eligible stakeholder company (s 809VC(3)). This rule will be breached if within two years of the investment being made 'the company has held no investments in any eligible trading company, or no eligible trading company in which it has held investments has carried on any commercial trade'. We read this section as only requiring some portion of the monies invested to be used to keep within the two-year start-up rule. We understand that this was not the intention and the sub-section will be amended.

92. It is not unusual for an investment to be made in a company who will then transfer the new trade into a subsidiary. We should be grateful for confirmation that the provisions of s 809VF(1)(a), to deem this a potentially chargeable event, do not apply in this situation.

93. We understand that amendments will be made to s 809VF to ensure that the interaction of ss 809VF(1),(8) and (9) do not interact in the event of a company ceasing to trade or becoming insolvent – this would incentivise the investor to remove their investment, thus making the situation worse.

94. The purpose of s 809VH(5) is unclear to us. We fail to understand why it is necessary for the proceeds to be taken offshore 'in the form in which they are received' to constitute an appropriate mitigation step. We suggest that the condition should be accepted as being met when property equivalent to the value of the proceeds is exported. This would also enable a taxpayer to take the appropriate mitigation steps in the following situations. The first is where the disposal of the investment has been made by a relevant person of the taxpayer who cannot be persuaded to export the funds. The second is where a tax charge is triggered under s 809VF(1)(b) and the person who ceased to be a relevant person cannot be persuaded to dispose of the investment and export the proceeds.

95. Section 809VH(6) requires amendment to deal with the situation when proceeds are taken offshore within the grace period but are subsequently imported to satisfy warranties under the sale contract.

96. We understand that s 809VJ(1)(b), which deals with the order of disposals, is being reviewed because in the case of a qualifying investment in an eligible stakeholder company, the individual has investments in that company not the eligible trading company in which the stakeholder company has invested. We agree and believe that this provision needs to be amended.

Schedule I Part 3 Sale of Exempt Property

97. We welcome the proposed exemption for the sale of exempt property. This should be of assistance to the UK arts market but there are changes that need to be made to ensure the exemption operates as intended.

98. Section 809YA(5) requires that the whole of the sale proceeds are paid to the seller within a period of 95 days if the provisions of s 809Y(1), ITA 2007 are not to apply. We understand that a number of sales are on deferred terms, which may breach the 95 day rule. This is often the case for expensive items and has the effect of increasing the pool

of potential bidders. If the ability to offer deferred terms is difficult in the UK, because of the tax consequences, vendors will simply go elsewhere. There will also be occasions when a purchaser pays late, in breach of the contract. An auction house will generally only release the proceeds after they have been paid. We therefore suggest that s 809YA(5) is removed and the grace period at s 809YA(6) starts with the day that the sale proceeds are freely available to the seller.

99. In connection with s 809YA(8) we would refer you to our comments at para 41 above. As no clearance procedure is envisaged under these provisions, this type of unclear anti-avoidance rule is likely to undermine confidence in this relief.

100. In para 809YA(6) we suggest that words '(or both)' should be substituted by '(or a combination of the two)' to be consistent with para 809VH(6)(b).

Schedule 1 Part 4 Nominated Income

101. These provisions amend s 809I, ITA 2007 to permit an individual to remit the first £10 of income or capital gains which they nominate free of tax and without becoming subject to the identification rules. In general we are happy with these provisions, although we would have liked the test to be set at a higher level.

102. We ask that these provisions be extended to include an election to permit individuals to amend previously nominated income/gains, the time limit for the election to be four years after the end of the relevant tax year. Such a provision would assist in reducing the large number of small bank accounts that are currently ring-fenced.

GIFTS OF PRE-EMINENT OBJECTS

Schedule 1 Part 1

103. Paragraph 1(2)(b) appears to deny the relief to an individual who is the sole beneficial owner of the object through a bare trust as the rules require that 'the person is legally and beneficially entitled to the property and the property is not owned jointly (or in common) with others'.

104. It is not clear to us why the existence of a different legal owner should prevent an individual claiming relief in this circumstance. The individual has an absolute entitlement to the object and the trust is effectively transparent for income tax and capital gains tax purposes, all income and capital gains in respect of the object are reported on the individual's tax return. We suggest that the legislation is amended to allow the relief for objects owned under a bare trust.

Schedule 1 Part 2

105. Paragraph 2(1) refers to 'an individual's liability to income tax and capital gains tax'. There is, however, no definition of what constitutes 'an individual's liability to income tax' in the draft legislation.

106. In the absence of a definition the logical definition would seem to be s 23, Income Tax Act 2007 (ITA 2007) where the calculation in this section results in 'the taxpayer's liability to income tax for the tax year'. Is it intended that the tax reduction under these provisions is to be included in Step 6 of the calculation in section 23? If that is the case we would expect an amendment to s 26, ITA 2007 but there is no amendment noted in the draft legislation.

107. It is not entirely clear, however, that s 23 ITA 2007 is the appropriate provision. Para 3(1) states that ‘a portion of N’s tax liability is to be treated as satisfied, as if N had paid that portion when it became due’. If N had PAYE sufficient to cover his entire income tax liability, and had no capital gains tax liability, there would be no amount becoming due for payment. We assume that in this situation that there would be a repayment of the PAYE deducted at source.

108. The legislation needs to include a definition of what constitutes ‘an individual’s liability to income tax’.

109. We welcome the fact that an individual donor is allowed to spread the tax reduction across five tax years. We do not, however, understand the requirement in para 3(3) that the allocation of the tax reduction is to be included in the agreed terms and that it cannot be subsequently revised, para 7(2).

110. We note from para 32 of the Guidance published by the Department for Culture, Media and Sport on 6 December 2011 that this is to allow the Panel to have certainty for future year commitments when managing the annual limit. This provision seems to us to be both inequitable to the donor and placing unnecessary constraints on the operation of the scheme.

111. A donor may be unable to accurately estimate their tax liabilities for the forthcoming five years; this is particularly the case where the donor is seeking a reduction in a future capital gains tax liability. It will not be unusual for a projected sale of an asset to be delayed, through no fault of the donor, to a later tax year.

112. In addition there does not appear to us to be any provision for unused amounts of the £30m annual limit to be carried forward. If all the donors in Years 1-3 agreed terms so that all the tax reductions would fall in Year 5 and these tax reductions total £30m it appears that the scheme would be closed for Year 5 as the annual limit had been reached. This would seem to be the case even if the annual limit had not been reached in earlier years.

113. In our view the scheme would be better served if the Panel was able to accept gifts, in conjunction with the Acceptance in Lieu scheme, to an annual limit of £30m, without the need to have regard to which tax years those reductions fall to be deducted. We also suggest that a donor should be able to amend the terms so as not to lose the tax reduction.

INHERITANCE TAX: GIFTS TO CHARITIES ETC

Legislation

114. On the draft legislation on the relief as it stands, we welcome that:

- the relief is being extended to registered community amateur sports clubs ;
- the calculations work as described in the accompanying notes;
- the elections procedure in new para 9 new Sch 1A provides a longer deadline (an extra month) for withdrawing than for making an election; and
- in para 9 under consequential amendments HMRC has adopted our recommendation that where such legacies are made by Instrument of Variation rather than through a Will, the beneficiary charities or registered clubs must be notified.

Explanatory Notes

115. In the draft Explanatory Notes, we suggest that Para 1, which may be the only bit that some read, may be misleading as it gives the impression that the relief is based on 10% of the total estate as valued for probate. We therefore suggest that 'net' or a similar qualifying word be inserted before 'estate' in the third line. Whilst not providing the full message (which can be obtained from the background note for those who read on), it will alert the reader to the fact that the baseline against which eligibility for the relief is measured is less than the total estate value.

PATENT BOX: CORPORATION TAX REFORM
Chapter 1 – Reduced corporation tax for profits from patents etc

116. We recommend that consideration should be given to recognising the patent box reduction in a form that enables it to be taken 'above the line' if as a result of the current consultation a similar decision is taken in relation to R&D tax credits.

Chapter 2 – Qualifying companies

Section 357BB

117. We hope that the power contained in subsection (1) (c) provides for the possibility of a 'white list' which will we believe be of great assistance in the proper working of this legislation.

118. We wrote in our earlier submission, TAXREP 41/11, in response to the question whether the new regime should be extended to patents granted by other EU national patent offices:

> 'We do believe that other EU or EEA national patent offices ought to be included, for instance Norway. We also note that neither Italy nor Spain have subscribed to the new European Patent Agreement , so exclusion of other EU patent offices would particularly adversely affect Italian and Spanish patents. We also believe that non EU national patent offices such as that of Japan also ought to be included.
>
> We believe the most practical way to cover this will be to establish a 'white list' of qualifying jurisdictions, both within and outside the EU, and for this list to be updated as and when appropriate but to be reviewed on a regular basis. Clearly the criteria for registration under the regimes of other countries must be comparable to those of the IPO or EPO in order for the countries to be eligible for inclusion on the list.'

Section 357BD(4)

119. We are concerned that this provision may cause one company in a group to carry on the development when that company is not necessarily the best person to do so and if the development by the non-owner of the IP rights produces significant value that may not be recognised in the patent box relief calculations of the original owner.

Chapter 3 – Relevant IP profits

120. We welcome the change to the routine return to 10% and feel that the categories of routine expenses are about right.

Section 357CB(3) and (4)

121. The intention of the legislation in relation to protected items and packaging is very clearly explained in paragraph 53 of the Explanatory Notes and it would be helpful to include a reference here to section 357CE(6) and vice versa.

Section 357CE(6)

122. As noted in the paragraph above it would be helpful to include a reference back to 357CB(3) and (4).

123. We also think it would be more practical to replace the term 'trivial' which could easily lead to disputes between the taxpayer and HMRC with a specific percentage.

Section 357CG

124. We believe that when the R&D expenditure condition is met then the percentage of the amount of expenditure incurred should be lower than the proposed 75% of average expenditure.

Chapter 4 – Streaming

Section 357D et seq

125. We welcome the simplification of the streaming rules.

126. We do have concerns that services cannot currently be included in the patent box. The service income model is often used by developers of IP and so merits inclusion.

Chapter 6 – Anti-avoidance

Section 357FB(5)

127. We are concerned at the very wide drafting which potentially means that any understanding, arrangement etc could be considered to be a scheme for the purposes of this legislation.

Chapter 7 – Supplementary

128. We are not sure why it is necessary to make a formal election for the patent box to apply. Is it not sufficient for there to be an appropriate claim in the tax computation to apply for the current and subsequent years until revoked? An informal election is acceptable for streaming in section 357D, as set out in paragraph 138 of the Explanatory Notes.

Specific responses – questions in consultation response document

Question 1: Do the proposed changes to IP ownership, development and active ownership rules now ensure that all innovative companies involved in the development of qualifying IP can potentially benefit from the Patent Box?

129. We think that is likely to be the case.

Question 2: Do businesses have any comments on how qualifying income within leasing transactions should be calculated?

130. If the income arises from the leasing of a qualifying product then the lease rental can be analysed into a payment in respect of the product itself, based on the arms-length selling price and the finance element. The element in respect of the product itself can be included in the patent box and the finance element excluded.

Question 3: Do businesses have any comments on the new proposals for removing profits attributable to marketing intangibles?

131. See our comments re Chapter 3 above.

Question 4: Do businesses have any comments on the proposed rules on the R&D floor?

132. See our comments re Chapter 3 above.

Question 5: Are the proposed anti-avoidance rules appropriate and effective?

133. See our comments re Chapter 6 above. .

CONTROLLED FOREIGN COMPANIES (CFC) REFORM

Gateway test

134. First of all we think the structure of the legislation, and the way it is set out, should follow the helpful diagram on page 5 of the 'Response to Consultation' document as this clearly establishes the role of the Gateway in eliminating at the initial stage businesses that are not intended to be caught by the CFC regime. So what is currently Chapter 8 of the draft clauses, setting out the Gateway test, should feature towards the beginning of the statutory provisions probably immediately after the definition of a CFC and should be clearly labelled as the Gateway test.

135. Moreover, the Gateway should be an exemption rather than another category of chargeable profits ie "bad income". What is potentially CFCable income is defined in Chapter 7 s 371GA(2) as the total of Chapters 8 – 12 profits as adjusted by Chapter 13 'amounts to be left out'. So even if you do not have CFCable income under the s 371HA – HK Gateway tests there are still categories of mainly finance income that remain CFCable ie Chapter 9 non-trading finance profits, Chapter 10 Trading finance profits, Chapter 11 Captives and Chapter 12 Solo consolidations. We accept that Chapters 10 and 12 are probably only of concern to banks and other financial traders. The Gateway is not therefore a true gateway, as in the debt cap rules.

136. Under the provisions of step 2 s 371H in Chapter 8, if there are no UK Significant People Functions (SPFs) relevant to the economic ownership of the CFC's assets/the assumption or management of the CFC's risks then there are no Chapter 8 profits

137. While this would appear to be a relatively clear test we believe that it is hardly ever likely to be met in real life. Subsidiaries in groups are hardly ever completely autonomous, for obvious commercial reasons.

138. Step 4, as modified by s 371HB via Step 5, then requires the provisional Chapter 8 profits, which come within the CFC regime, to be determined by taking out of the potential CFCable profits those that are attributable to UK SPFs where these are no more than the CFC's profits re its assets/risks attributable to non-UK SPFs.

139. Again, when deciphered, this looks like a generous exemption but will it require a full functional transfer pricing analysis for every CFC everywhere in the world? And will the analysis require an asset by asset/risk by risk assessment which would be incredibly onerous? We accept that other exemptions eg the Chapter 6 s 371FA Tax Exemption (which we think should be called the Not Low tax or Designer rate Exemption) may apply but we thought the whole purpose of the Gateway was to screen out 90%+ of foreign subsidiaries, without the need to refer to the rest of the legislation.

140. There are then a number of further tests under Step 5 under which profits will be excluded from the CFC regime.

141. Apart from the exclusions already mentioned above, if there are UK SPFs but by having the CFC involved the group has generated ‘substantial’ non-tax value then even if the CFC uses the SPFs in relation to its assets and/or risks then there will be no Chapter 8 profits (s 371HC).

142. This is akin to a commercial purpose test but ‘substantial’ is undefined. Is it intended that this test will be similar to the 20% threshold that applies in the Substantial Shareholding Exemption (SSE) legislation? What evidence will HMRC require re valuation?

143. Inevitably because of valuation issues it is also going to be an extremely subjective test.

144. There is then an arm’s length exclusion under s 371HD so that if there are UK SPFs but the arrangements would have been entered into on the same terms with a third party, in relation to the UK SPFs, then the CFC has no Chapter 8 profits.

145. Again, will it be necessary to carry out a full transfer pricing comparables exercise in order to self-assess this issue? What documentation requirements will there be?

146. Section 371HE is the final provision under which profits can be excluded from the CFC regime and it, in turn, has ss 371HF to HJ to explain what each of the provisions in s371HE actually means.

147. These provisions in effect reflect a trading income version of the ‘Cadbury’ let out but we are very concerned that they are terribly complicated and only very distantly related to Cadbury.

148. The various let outs are that the CFC:

- is genuinely established in terms of business premises (s 371HF);
- no more than 20% of its trading income (excluding interest and income from goods made by the CFC in its residence territory sold to the UK) come from UK residents or UK PEs of non-UK residents (s 371HG);
- no more than 20% of its management expenditure relates to UK based staff (s 371HH);
- does not hold IP transferred out of the UK within the last 6 years as a result of which the value of IP held by group companies other than the CFC is significantly reduced (not taking account of the other trigger re the transfer of only parts of the IP) (s 371HI) and
- no more than 20% of the its trading income is in relation to goods exported from the UK (but excluding goods exported into the territory of the CFC) (s 371HJ)

149. The first requirement comes from the Court of Justice of the European Union (CJEU) judgment in *Cadbury Schweppes plc v Commissioners of Inland Revenue* C-196/04 but there is no EU law basis for any of the other requirements. The SGI decision is of no relevance as Belgian TP has an inbuilt commercial purpose test.

150. Finally there is a TAAR for the gateway (371HK). We counted 6 TAARs **[in our later TAXREP 8/12 we identified 11 TAARs]** in the draft legislation. This is not going to assist in achieving legal certainty.

Compatibility with EU law

151. Amongst other things, Chapter 9 picks up interest on upstream loans to the UK (s 371D). We can fully appreciate why this was considered necessary from a UK policy perspective but we cannot see that there is any basis in the Cadbury Schweppes CJEU judgment for such a provision and we question whether it is compliant with EU law without a commercial purpose test.

152. We are also concerned that the fat cap test in Chapter 10 may not be EU law compliant. This may be based on the *SGI* judgment of the CJEU but as noted above that was by reference to Belgian transfer pricing rules which have an inbuilt commercial purpose test which the proposed new UK CFC rules do not have. So even if you come out from the CFC under the 'substantial' non tax value in paragraph 18 above you could still face CFCable income under Chapter 10 because there is no overall commercial purpose get out (see s 371GA(2)) which defines the new CFC charge as the total of Chapter 8 to Chapter 12 profits.

Drafting

153. Lastly, the drafting is appallingly dense. By comparison, the draft GAAR, or the King James Bible, or even arguably Spenser's Faerie Queene are more intelligible..

Detailed comments on CFC Reform proposals

Chapter 1 - Introduction

Section 371AE

154. We are concerned by the uncertain implications of the word 'reasonable' as what is reasonable to one person is not necessarily the same for someone else. This seems to us to be too subjective a test.

155. We believe the provisions should only apply to artificial arrangements.

156. This section contains the first of a number of TAARs and it was agreed at the 11 January 2012 Open Day that an exercise would be undertaken to look at each of the TAARs throughout the CFC provisions to decide whether all of them are absolutely necessary.

Chapter 2 – The CFC Charge

Section 371BB

157. We are not clear why an accounting period should end when (sub-section 3(d)) a company ceases to have a relevant interest in the CFC. It would seem more appropriate to craft the definition from the perspective of the owner of an interest in the CFC as is done for the loan relationship provisions in ss 381/385 Corporation Tax Act 2009 re the loan relationship regime.

Chapter 3 – The low profits exemption

Section 371CE

158. Conditions A and B are both subject to TAARs which are to be reviewed.

Section 371CG

159. This contains TAARs No 4 and 5.

Chapter 4 – The low profit margin exemption

Section 371DB

160. It is not clear why relevant operating expenditure should be excluded just because, for instance, it gives rise to income of a connected person if it is ‘good’ expenditure which would have been incurred in a purely arm’s length situation.

Chapter 5 – The excluded territory exemption

161. At the Open Day on 11 January 2012 it was agreed that some of the conditions were going to be reviewed which we welcome.

Section 371EB

162. This contains TAAR No 6.

Section 371EE

163. We are concerned that the provision in sub-section 4 is very broadly drafted. For example, we wonder how this provision will operate in relation to all the other patent box regimes established in EU countries?

Chapter 6 – The Tax Exemption

164. This was previously the ‘low tax exemption’. We welcome the comment at the Open day that HMRC are considering not requiring UK groups to include details of not low tax subsidiaries as not being CFCs.

Chapters 7 to 12 – the Gateway test

165. We submitted comments on the Gateway test in TAXREP 70/11 submitted before Christmas. Our comments are reproduced in Appendix 1 to the present document.

166. We note that s 371HK contains TAAR No 7.

Section 371HF

167. We have an additional point since we submitted our earlier paper, TAXREP 70/11. Subsection 3 extends the Premises exclusion to some OECD Permanent Establishment definitions but not to all of them. We believe the definition should be extended to dependent agents, services and offshore exploration activities.

168. A practical example of where the dependent agent definition is necessary would be where a CFC has no premises but employs a salesman to sell its product, the salesman having no office but staying in hotels. Similarly a CFC's only presence in its territory might be represented by consultants carrying out services for a client, or engineers carrying out offshore exploration activities.

Chapter 13 – Chargeable profits of a CFC – amounts to be left out

Section 371ME

169. In line 4 of sub-section 4 the word ‘of’ is omitted between ‘proportion’ and ‘its’.

Chapter 16 – Apportionment of a CFC’s chargeable profits and creditable tax

Section 371FC

170. We found these provisions particularly difficult to understand.

Chapter 17 – Loan relationships with connected companies

171. We found this chapter too compressed and we believe it would benefit from being expanded with a preamble to define the mischief it seeks to combat.

172. We note TAAR No 9 in s 371QD subsection 9.

Section 371QD

173. If bad income reduces good income then in our view it should become good income as is the treatment in equivalent circumstances in Canada.

Chapter 18 – Assumed taxable profits, assumed total profits and the corporation tax assumptions

174. TAARs 10 and 11 are contained in ss 371RL and 371RM.

CFC Reform – additional comments on draft clauses etc published on 31 January 2012

Temporary Period Exemption

175. We are concerned that restricting the temporary period exemption to 12 months rather than the 3 years envisaged in the June 2011 Consultation Document is going to present very considerable difficulties for multinational groups following a major acquisition.

176. We understand that there is concern that a longer period than 12 months would fall foul of the TFEU State Aid provisions. Our view, however, is that the case of Paint Graphos C-78/80-08 sets out circumstances where State Aid can be justified as being proportionate and supportable on public policy grounds and we believe that case is directly relevant to these CFC Reform proposals.

Chapter 17 – Exemptions for profits from Qualifying Loan Relationships

177. We welcome the expansion of this Chapter which we commented on in our earlier paper, TAXREP 8/12, as being too compressed.

178. We welcome the provision in section 371QC which provides for the complete exemption from profits, in the stated circumstances, rather than the 75% exemption provided for in section 371QE.

179. We also welcome the removal of what had been section 371QD(6) which would otherwise have been section 371QH(6) in the 31 January redraft.

180. We think the new anti-avoidance provisions in section 371QH(9)-(11) are arguably too widely drafted, particularly the “wholly or partly and directly or indirectly” wording of section 371QH(9)(b). We would request that the HMT/HMRC/business working group monitoring TAARs discussed at the 11 January 2012 Open Day be asked to comment on the need for, and the drafting of, these provisions.

Part 2 – Foreign Permanent Establishments

181. We are disappointed that the foreign branch exemption is to be restricted to trading companies.

182. We remain concerned that, following the Adria-Wien Pipeline case C-143/99 and the Commission negative decision against Ireland regarding an exemption for dividends/foreign branch profits remitted to Ireland and reinvested there that the restriction of the UK foreign branch exemption to trading companies may amount to a horizontally selective measure constituting recoverable fiscal state aid.

NEW SEED ENTERPRISE INVESTMENT SCHEMES (SEIS) AND CHANGES TO EIS AND VCT SCHEME RULES

183. Of particular concern are the following clauses:

- Disqualifying arrangements, s 178A and s 257CF, ITA 2007.
- Prohibition of acquisitions as a qualifying business activity, s 179, ITA 2007.
- Forbidding EIS relief for paid directors following SEIS investment, S169, ITA 2007.
- Restricting the possibility for corporate investment under the SEIS through the gross assets test, s 257DJ, ITA 2007.
- The no subsidiaries rule under the SEIS, s 257DH, ITA 2007.

The no disqualifying arrangements requirement, s 178A and s 257CF

184. It seems that this drafting will catch arrangements where investors make it a condition of their investment that the company is a qualifying company for the purposes of the relief. For example, consider an existing company which carries on a business of manufacturing Smoothies. The directors want to manufacture other fruit products. They approach an investor who will only invest into a new company and that new company must be a qualifying company for EIS purposes. They set up the company and the investment.

185. This would seem to be caught as this could have been carried on as part of their original business. Is this the intention?

186. If an existing company sets up a new company with the intention of hiving off an existing trade this will be caught by the changes to "qualifying business activity" so this section is not required to prevent that.

187. It would be helpful if HMRC could publish some examples of what this is seeking to catch. We set out an illustration of the practical problem this causes for very small new businesses and have set out further scenarios which we believe may be caught in Appendix 2.

Illustration

Jake is a T shirt designer who left college in July 2012.
He buys plain T shirts and makes his own designs which he has printed on for him using a printing business he found on the internet. He trades through J Ltd.

In late November a local school agrees to place an order with Jake for 800 T shirts provided they can be delivered before the last week of term. Otherwise they will buy them from their existing supplier of school uniforms in Hong Kong. Jake knows he can only meet this deadline if he buys his own printer, which will cost £5,000.

Jake's former tutor from art college (Bill) says he will invest in his business and subscribes for £5,000 new shares for which Jake gives him 30% of the company.

Is SEIS relief available?
Are these disqualifying arrangements?

Section 257 CF(2)

(a) (i)The main purpose of the arrangement is to secure that J Ltd carries on a business which consists of printing T shirts, and
(ii)Bill will get tax relief for the shares which raise money for the activity, and

(b) Condition B is that it would have been reasonable to expect that the T shirts would have been carried on as part of another business (in Hong Kong)

Conclusion: We would say yes they are

188. S 178A (2) (a) the word 'secure' is undefined and is far too wide. It would be helpful if either, 'secure' could be defined, Condition B is refined so that normal financing 'arrangements' are excluded or there is an overall exclusion for normal commercial financing.

Change to "Qualifying Business Activity", s 179 and s 257CF(6)

Scenario	**Analysis**
1) Newco is set up and attracts EIS investment. The funds used by Newco are used to acquire the entire share capital of a company carrying on a qualifying trade.	Under the proposed changes to s 179 it would now be disallowed as the target company shareholders would receive cash as part of the transaction.
2) Newco is set up and attracts EIS investment. Newco subsequently acquires an existing company on a share for share exchange with no cash. The EIS monies are used to develop the trade further.	Under the proposed changes to s 179 this transaction would not be allowed as the shares were not subscribed for. This is the case even though the monies have not passed to the shareholders of the target company.
3) Newco is set up and attracts EIS investment. The money is used to subscribe for new shares in a target company and that money is used to repay the loans owed to those shareholders.	Is this allowed?

189. In our view, Condition B, is unduly onerous as currently drafted. Unless the intention is to restrict SEIS/EIS relief to just those businesses which are undertaking unique research and development business activity, it is almost certain 'to expect that the component activities of the relevant qualifying business activity would have been carried on as part of another business'.

190. We suggest restricting condition B to apply only where the business would have been carried on by a person connected in any way to the investor or the investee.

Further detailed points on specific clauses

Venture capital trusts

S 287, ITA 2007

191. Removing the £1m per VCT is welcome and simplifies the administration of the scheme.

S 291 (3A), ITA 2007

192. This effectively prohibits share acquisitions of companies using VCT (or EIS funds). It is prejudicial to companies which seek to grow non organically, to buy and build or rationalise fragmented industry sectors.

193. This prevents shell company investments where there is a subsequent acquisition of the shares of the trading company, even where the funds raised are to be used for working capital purposes.

Section 292, ITA 2007

194. The increase from £2m to £10m is welcome, but the applicable amount that can be raised will depend on the existing gross assets of the company. The original Budget note referred only to a gross assets limit of £15 million before venture capital scheme's investment thus indicating a further £10 million could possibly be raised. This, in our opinion, would have more accurately reflected the 'equity funding gap'. Transfer pricing legislation refers to £43m and EMI £30m.

Section 297, ITA 2007

195. The increase in gross assets requirement is welcome but see our point re s 292 above.

196. The increase in employees to 250 in section 297A is also welcome, but it is difficult to see how this is commensurate with gross assets limited to £16m. A gross assets limit nearer £25m would be more appropriate.

Section 299A, ITA 2007

197. This is extremely difficult to understand, is very wide ranging and subjective. We believe is not workable in its present form and without further definitions of 'party' and 'connected'. It will require a very detailed guidance note.

198. We conclude that while this will sensibly exclude say a large company hiving off a small activity to a VCT backed company and the larger non qualifying company effectively receiving VCT funding when it could simply carry on that activity itself, it will or could (possibly in conjunction with s291 3A) exclude the following:

- All acquisitions of shares
- MBIs
- MBOs whether or not EIS relief is claimed by the management team
- Secondary buy outs
- Certain trade and assets purchases

199. Whether or not all the above are excluded is not conclusive and is subjective. We recommend that HMRC sets out the specific examples which they seek to prohibit and seek assistance from industry professionals in order s to draft the appropriate amendments to the legislation.

200. At present it is unclear as to who will be considered to be a party to arranging the issue of the shares in different circumstances eg vendor, purchaser, directors of vendor,

directors of purchaser, VCT or EIS investors. As drafted the legislation could actually be interpreted to include all fund raisings where VCT or EIS funds are to be raised.

201. We consider that the legislation would better be drafted to include a prohibition of an ongoing material commercial involvement by the relevant party.

202. We understand that MBOs are forbidden by EU State Aid requirements and this section is intended to capture them as well, but would point out that the very vast majority in our experience do not work to allow EIS relief to the management team on account of ss 232 and 233 ITA 2007.

Enterprise Investment Scheme

Section 158, ITA 2007

203. The increase in the individual investment limit to £1 million is extremely welcome

Section 169, ITA 2007

204. There is an omission to the draft legislation**:**

205. Under the SEIS a director who has invested under that scheme can receive reasonable remuneration from the company before or after investment. The intention would be that the company can obtain further investment after the EIS after the SEIS funds have been spent, one further source of this EIS investment would be its founder directors who invested the seed capital.

206. Section s169 has not been changed to factor in the effect of the SEIS: If a director who has made an investment under the SEIS wished to make a further investment into the company he would be precluded from EIS relief if he had drawn a salary following his SEIS investment but before any EIS investment.

207. We would hope that s169 is amended at subsection (4) to also include "shares which met the definition of relevant shares under s 257CA issued before the termination date of those shares.

Section 170, ITA 2007

208. The removal of loan capital from the 30% test is most welcome and removes a number of anomalous situations.

Section 172, ITA 2007

209. Disqualifying Arrangements and acquisitions – see earlier comments re VCTs

Seed Enterprise Investment Scheme (SEIS)

210. Overall this is a welcome addition to the venture capital schemes.

211. To make the numbering of the legislation less cumbersome and more readily identifiable, we recommend that s 257A should become a schedule to ITA 2007 (we would assume schedule 5).

Section 257 BA (1)

212. Why should a former employee be barred from investing under the scheme? A full time sales director would qualify but a full time sales manager would not. We note that this mirrors s167, ITA 2007 for EIS, but do not see why this restriction should also be applied to the SEIS.

Section 257 CA (3)(a) ITA 2007

213. No dividend can be paid without a decision (existence of reserves, continued solvency etc.) being made by a company. The only conceivable structure would be setting up a third party escrow of cash to pay dividends automatically, which is impossible under s 257 CB.

214. We note that this wording mirrors the EIS. In order for a preference share to be a qualifying share for EIS and VCT purposes it must not have any preferential right that is discretionary or cumulative.

215. The literal reading of this wording is that a dividend cannot be paid on an ordinary share if holders of preference shares are not entitled to the same dividend, as it could be argued that such a dividend would be preferential. We would like HMRC to clarify this.

Section 257 CA (5)

216. We understand the term 'incapacity', but do not understand the need for the wording 'incapacitated by…..other cause'?

Section 257 CC

217. The wording used in this clause requires all the money to have been spent on the qualifying activity within (broadly) 3 years. It goes on to say that the relief won't fail just because an insignificant amount may have been spent for another purpose. This is different from the situation where not all the money has been spent and a small sum is still retained.

218. We consider that the provision should also allow a minor amount to be left unspent.

Section 257 DA, ITA 2007

219. We do not see why it is necessary for the issuing company to be under two years old. We appreciate that the relief is for new businesses, but feel it should be extended to companies that haven't traded or received any investment income to date, ie dormant companies that may have been incorporated earlier.

Section 257 DB (2), ITA 2007

220. We consider the use of the term 'wholly' to be too strong. 'Incidental' should be defined. It is likely that such incidental matters would relate to small non cash assets on the balance sheet, but as the company can only have a maximum of £200,000 of gross assets prior to any investment, it seems unlikely that many of these will be non-trade items.

Section 257 DD (1), ITA 2007

221. We understand that HMRC solicitors say this legislation does not preclude subcontracting, but we are unconvinced. If the intention is to allow assistance by third parties for specific tasks, we do not consider (1) (b) and (c) are then necessary.

222. This clause needs to be made clearer.

Section 257 DH, ITA 2007

223. The draft legislation would appear to prevent any subsidiary being created in the three year period following investment, which may not be commercially sensible.

224. If a company wishes to expand abroad it may be beneficial to set up subsidiaries in these territories as opposed to operating there through a branch.

225. We understand that HMRC has not included the extra clauses needed to allow for subsidiaries in order to restrict the length of the legislation. We consider this to be a false

economy. As the legislation already runs to 47 pages, three more won't be a material addition.

Section 257 DJ, ITA 2007

226. This is likely to preclude any corporate investor from being able to hold more than 25% as its proportion of gross assets will be included within the £200,000 test. This seems to be unnecessarily restrictive.

Section 257 EC (6), ITA 2007

227. A time limit for HMRC to give its response to the issuing company would make good sense commercially.

Section 257 (FH) (11), ITA 2007

228. Remuneration for services as a director in this sub clause could simply be added to the list of 'excluded payments' in sub clause (3)

Section 257 HC, ITA 2007

229. The expression 'genuine new venture' is very difficult to define. Considerable guidance will be needed on this.

230. The policy objective of the SEIS is to help '…smaller, riskier, early stage UK companies, which may face barriers in raising external finance, to attract investment, making it easier for the companies to be established and to grow.'

231. In addition, the relief is not available where an investor wishes to help a small unincorporated business which has already begun to prove its business model by making early sales.

232. A member has told us of a recent case of a business set up to supply goods over the internet. The girl left school with GCSE's and an interest in fashion and beauty and began buying and selling Ugg boots, sourced from China. She then realised that there was also a market for quality hair extensions. As it happened she was financed by friends and family, but not all such businesses have that option available. On incorporating last year, had she sought venture capital finance from third parties, she would have been ineligible for the SEIS, having already started trading. Yet without first proving her business model, she would have found raising funds difficult. Setting up a company before starting to trade is unduly onerous and does not make good business sense for young entrepreneurs who usually have little or no business advice, yet that is what these rules require.

233. We accept that EIS relief is available, but do not see why the more generous SEIS should not also be given to these very risky start ups when they incorporate. Perhaps restricting the relief in such cases to unconnected parties might be a way forward?

234. Section 257HC(2) says '...if subsection (3) or (6) applies'. We believe this should read '....if subsection (3) applies'.

235. Section 257 HC (4), second line, second occasion of use of the word 'on' should, we think, be 'of'.

236. What is the position where an approved EIS fund invests in an SEIS? The Approved Fund legislation does not appear in the draft SEIS legislation, which suggests that there could be several treatments, particularly as the Nominee legislation has been transferred suggesting that an unapproved scheme does work for SEIS.

237. As s 251 is not replicated as s 257HC (which is where we would have expected it to be), this seems to suggest that approved funds do not extend to SEIS shares. However, this exclusion does not seem to have any logic, especially as the nominee provisions in s 250 have been replicated in s 25 HB almost word for word. Please could HMRC explain the omission or replicate the provision?

TAXPAYER'S AGENTS: DISHONEST CONDUCT

Conduct notice

238. Para 4(4) states 'For the effect of notifying the individual, see paragraphs 7(2) and 29(2)', ie, what are the consequences of publishing a conduct notice. While we can see that the ref to para 29(2) is probably correct (liability to a penalty), we not convinced that the reference to para 7(2) is correct. Should the reference to para 7(2) instead be to para 8 (file access notice)?

Content of notice

239. Para 10(1)(b) states that a file access notice may require the provision of all relevant documents in the document-holder's possession or power. This may be difficult to determine where, as will usually be the case, the documents will not be in the possession or power of the tax agent but will be with a third party, such as a firm for whom the tax agent works. The third party may not know what are and are not relevant documents.

240. Para 2.32 of the summary of responses document published on 6 December states that

> *The third party or the agent can make representations, so there is already a channel to discuss in advance any issues with the notice.*

241. We are concerned about the way this operates in respect of third parties who were not involved in the dishonest conduct. For example, suppose a firm employs someone who introduces a client to the firm. Subsequently the employee dishonestly colludes with the client to evade tax. When the firm discovers this the employee is sacked. The firm asks the client for permission to tell HMRC what has happened but the client refuses. The firm writes to HMRC to say that it no longer has confidence in the accounts submitted on the client's behalf and tell the client the firm can no longer act (as required by the ethical rules). HMRC launch an investigation into the client and discover the dishonesty. They issue a conduct notice to the ex-employee. By that time he has left the country and either does not receive the notice or ignores it. HMRC ask the tribunal to issue a file access notice against the firm. Although the firm can make representations, it is still not entirely clear from the draft what actual rights the firm has to attend any Tribunal hearing and raise objections.

242. It is our understanding that in the above example the firm will have such a right, but this needs to be made clearer. We suggest it should be backed up by a Ministerial statement and confirmed in HMRC guidance.

243. More generally, the third party notice provisions will be of crucial importance in many situations and it remains to be seen how these rules will work in practice. We recommend that HMRC consult further with the tax agents about how these provisions will apply in practice and publish agreed guidance about the procedures and practicalities of such notices.

Power to publish details

244. We remain concerned about the proposal in para 28 to publish names of those who have incurred a penalty under para 26 of more than £5,000. We agree that there is no place in the tax system for dishonest agents. However, these are very serious provisions that could destroy a business, so they need to be introduced with care.

245. We recognise that currently there is not a level playing field between affiliated and unaffiliated agents and that this proposal will ensure that the names of unaffiliated agents engaged in dishonest conduct will be published. Nevertheless we are concerned that under these proposals the FA 2009 provisions will be extended to agents when we do not know how these provisions will work in practice. We would also note that Ireland, which has had similar rules for taxpayers for many years and upon which the UK provision is based, has never extended the rules to include tax agents.

246. We appreciate the policy intention but believe that there is a case for this to be limited to unaffiliated agents, or cases where the professional body does not publish the name of members found guilty of dishonest conduct. Currently, tax agents who engage in dishonest conduct and who are members of a professional body to whom a complaint has been made are likely to face disciplinary hearings. They are, therefore, already subject to rules that can lead to public naming.

247. In contrast, unaffiliated agents are not subject to such measures unless of course HMRC pursue a criminal prosecution. There is a risk, which we accept may be small, that publishing a person's name may discourage membership of a professional body as it might result in that person being named twice, once by their professional body and once by HMRC. We therefore suggest that the behavioural impact of these measures is kept under review.

248. There is a case that the FA 2009 publication rules for taxpayers should be allowed to bed down for a period of time before any decision is taken to bring this particular paragraph into force. The intention is to bring the dishonest conduct provisions into force in April 2013, so we think it is reasonable to defer the start date for para 28 to, say, April 2014 while the file access notice and penalty provisions (and the FA 2009 taxpayer publication rules) are allowed to bed down and any practical problems in their operation highlighted. This should help ensure that the provision is properly targeted at dishonest agents.

INFORMATION POWERS

249. In TAXREP 59/11 we said that any extension to the information powers should be no more than is absolutely necessary to enable the UK to satisfy its international information exchange requirements, and we would be concerned if domestic powers were widened. We recommended that of the three proposed methods of amending Sch 36, FA 2008, the third method should be adopted. We are pleased to note that this is the approach which has been taken.

250. We have some comments on aspects of the latest draft clauses.

251. Most importantly, we are concerned that the draft legislation now includes a new para 5A(7) to Sch 36, which was not in the July 2011 draft. We think this is far too widely drafted. We appreciate that it is intended to cover joint accounts (as explained in the December 2011 summary of responses, at para 2.17). However, the new para 5A(7) is written far more widely than that and could in theory extend to all bank customers with UK addresses but overseas bank accounts. The wording should be made much more specific to deal just with the joint account situation it is intended to address.

252. As an example of the effect of the current wording of new para 5A(7), we think there is a risk that HMRC could use it to go to a firm of accountants and ask for a list of the names and addresses of all of its clients who have used a scheme which HMRC considers to be an abusive marketed tax scheme. This would be a very major extension of HMRC powers and would undermine the ongoing HMRC consultation on working with tax agents.

253. In para 5A(5), condition D refers only to data held by 'the officer'. We recommend that this should refer to data held 'by HMRC'. The officer should be required to make sure that the information about the taxpayer's identity is not held elsewhere in HMRC, before he or she issues the information notice. Amending condition D in this way would ensure that this is done.

254. We would also like an assurance (possibly as an alternative to amending condition D) that the HMRC officer will take reasonable steps to search for the information elsewhere within HMRC before burdening a third party with an information notice. This should be incorporated in HMRC guidance.

255. Unlike other Sch 36 third party notices, there is no requirement to obtain tribunal approval beforehand. We understand that (as explained in paragraph 3.12 of the July 2011 consultation document) this is because HMRC envisages that this could mean that it takes too long to obtain the information requested by an overseas jurisdiction.

256. However, the right of appeal against the information notice is restricted, as it only applies where it would be unduly onerous to comply with the notice. We are concerned at the implications of this restricted appeal right coupled with the lack of any requirement for prior approval from the tribunal. We do not think the grounds for appeal cover all the situations where a third party might quite reasonably be unable to comply with the notice. For example, they may no longer have the information, having destroyed it once the required record-keeping period has passed. In this case, there are no grounds of appeal (the 'unduly onerous' grounds do not apply) and if HMRC does not accept that the third party does not have the records, the latter must wait for HMRC to issue a penalty notice and appeal against that.

257. We should like to repeat two comments made in our earlier TAXREP 59/11 with regard to safeguards and how the power is operated:

258. HMRC should only use the new power where the third party can be expected to be able to identify the taxpayer from the information given, and can do so without a disproportionate compliance burden. We trust that HMRC guidance will make this clear and also clarify what sort of identifying information HMRC must hold before issuing a notice to a third party.

259. We think that an additional safeguard would be for HMRC to provide a report on the use of this new power. This could be an annual report and would set out how often the power had been used and whether it was used solely in connection with information exchange requests or for domestic purposes as well.

Further contact

260. For any further enquiries please contact:

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APPENDIX 1

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.com/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx).

APPENDIX 2

FURTHER ACQUISITION CONSEQUENCES OF DRAFT FINANCE BILL CLAUSES

No		Allowed/Disallowed	Reason
We have taken the opportunity to outline what we expect the consequences of s179 2A and s291 3A will be in respect of newly-incorporated companies looking to acquire the business of an existing trading company, whether by shares or trade and asset sale			
1	NEWCO preparing to carry on its trade raises EIS/post April2012 VCT funds and makes acquisition of shares for Cash of qualifying trading company using EIS or VCT funds	Disallowed	At the time of issue, the business activity of the company is "preparing to trade. The trade itself arises out of an acquisition of shares which is not shares by subscription therefore specifically precluded by S179 2A and 291 3A
2	NEWCO preparing to carry on a qualifying trade makes acquisition of shares using non EIS or VCT funds but employs EIS or VCT funds for working capital in the acquired company	Disallowed??	At the time of issue, the business activity of the company is "preparing to trade. The trade itself arises out of an acquisition of shares which is not shares by subscription therefore specifically precluded by S179 2A and 291 3A
3	NEWCO preparing to carry on a qualifying trade makes acquisition of trade and assets of target using EIS/post April 2012 or VCT funds	Allowed	Trade and asset purchase not caught unless a disqualifying arrangement
4	NEWCO preparing to carry on a qualifying trade makes a share for share acquisition of a qualifying trading company and then raises EIS/post April 2012 VCT funds and employs for working capital in the enlarged group	Disallowed??	At the time of issue, the business activity of the company is "preparing to trade. The trade itself arises out of an acquisition of shares which is not shares by subscription therefore specifically precluded by S179 2A and 291 3A

The following situation concerns a company which incorporates on Day 1, purchases the business of the Target on Day 2 (using Non EIS funds or share for share exchange) and the issue of EIS VCT shares occurs on Day 3 ("the issue"). In each situation the group would be considered as carrying on a qualifying trade at the date of issue. The gross assets of the company immediately before the issue would include the enlarged trade and, accordingly, the group meets the size conditions under which the legislation is intended			
5	EXISTING qualifying trading company raises EIS/post April 2012 VCT funds and uses these to fund working capital of the trade	Disallowed??	The business activity consists of a qualifying trade carried on by the Group. However the trade arose in the group by an acquisition of shares, not by subscription in a company which is carrying on the qualifying

<table>
<tr><td></td><td></td><td></td><td>trade. Accordingly this is precluded by s179 2A and s291 3A.</td></tr>
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<table>
<tr><td colspan="4">The following situation concerns a company which incorporated in 1994 and purchased a trading company that year through a share for share exchange. The group has been trading for the past 17 years in which time there has been no major change in the nature or conduct of trade, meaning the trade carried on now is inherently the trade that was purchased 17 years ago. The gross assets of the company would include the enlarged trade and, accordingly, the group meets the size limits before the issue of shares under which the legislation is intended. (we have an actual example of this)</td></tr>
<tr><td>6</td><td>EXISTING qualifying trading company raises EIS/post April 2012 VCT funds and uses these to fund working capital of the trade</td><td>Disallowed??</td><td>The business activity consists of a qualifying trade carried on by the Group. However the trade arose in the group by an acquisition of shares, not by subscription in a company which is carrying on the qualifying trade. Accordingly this is precluded by s179 2A and s291 3A. Despite the fact that such an acquisition occurred 17 years ago
The question is what does a trade consist of?</td></tr>
<tr><td colspan="4">The following situation concerns a company with gross assets of £12m which commenced its own trade several years ago and is looking to expand. It has identified a target company which is worth £8 million. The trade of the target is the same as that currently carried on by the company in that, post-acquisition, the trades of both entities would be considered as part of the overall trade of the group. In each case EIS-VCT funds would be raised prior to any other investment and up to the gross assets limits expected to be in place post 6 April 2012
The enlarged group would, of course, be greater than the size limits for which the legislation is intended.
The following scenarios are prepared on the basis that the group carries on a qualifying trade irrespective of whether it hives up the trade of its target into the parent company post acquisition of the shares. However, if a hive-up would be required in this circumstance please advise accordingly.</td></tr>
<tr><td>7</td><td>EXISTING qualifying trading company raises EIS/post April 2012 VCT funds and uses these to acquire the shares for cash of a qualifying trading company</td><td>Allowed</td><td>The group is carrying on a qualifying business activity. The acquisition of the target is not itself a separate qualifying business activity and, accordingly, the use of the money raised to buy the Target’s shares is used for the purposes of the company’s qualifying business activity. Accordingly s179 2A and s291 3A do not apply.</td></tr>
<tr><td>8</td><td>EXISTING qualifying trading company raises EIS/post April 2012 VCT funds but acquires a</td><td>Allowed</td><td>The relevant qualifying activity is the trade, which itself did not exist as a result of an acquisition and any acquisitions augment</td></tr>
</table>

	qualifying trading company using non EIS/post April 2012 VCT funds – EIS and VCT for working Capital only		the existing trade. Accordingly s179 2A and s291 3A do not apply.
9	EXISTING qualifying trading company raises EIS/post April 2012 VCT funds to acquire the trade and assets of a qualifying business from a vendor company	Allowed	Not a share acquisition so OK unless a disqualifying arrangement. Unlikely to be a disqualifying arrangement as the company would be a qualifying holding anyway, therefore the arrangement to purchase the trade and assets from the previous vendor cannot be part of any agreement to secure EIS and VCT tax reliefs.
10	EXISTING qualifying trading company raises new EIS/ post April 2012 VCT funds, acquires a qualifying trading company by way of share for share exchange but employs the EIS and VCT funds in the acquired company for working capital	Allowed??	The qualifying business activity, for which the money was raised, does not consist of an acquisition of shares. The group is already carrying on a qualifying trade which has not consisted of an acquisition of shares. Accordingly s179 2A and s291 3A do not apply
The following situation concerns a newly-incorporated company which is looking to purchase a company in difficulty. The target has significant bank loans which the bank will sell to the new company at a significant discount. The company will raise EIS and VCT funds prior to any other funding. It will then purchase the loan notes and then, on the same day, subscribe for so many shares in the target which will give it 90% control of the target. The consideration for these shares will be the loan notes it holds owed by the company.			
11	NEWCO preparing to carry on a qualifying trade makes acquisition of debt using non EIS or VCT funds, which are subsequently exchanged for share capital. EIS and VCT funds used for working capital in the acquired company	Allowed	The qualifying business activity arises as a result of an acquisition of shares in a company by subscription, immediately before which the company is not a 90% subsidiary, and after which the company is a qualifying 90% subsidiary. Accordingly s179 2A and s291 3A would not apply.
12	NEWCO preparing to carry on a qualifying trade makes acquisition of debt using non EIS or VCT funds, which are subsequently exchanged for share capital.	Disallowed, but not as a result of s179 2A or s291 3A	In this circumstance the money raised would be used to purchase debt. The use of the money raised is accordingly money-lending which is excluded under s192 and s303 and not wholly for a qualifying activity/