TAXREP 21/01

LARGE BUSINESS TAXATION

Text of a memorandum submitted in September 2001 in response to a consultation paper published by the Treasury and Inland Revenue in July 2001

CONTENTS

`

LARGE BUSINESS TAXATION:

THE GOVERNMENT'S STRATEGY AND CORPORATE TAX REFORMS

INTRODUCTION

1 We welcome the opportunity to comment on the issues raised in the Treasury/Inland Revenue consultation document published on 19 July 2001.

2 We responded to the Technical Note published on 8 November 2000 in December 2000. Our response was published as TAXREP 39/00.

3 We have also been involved with the ongoing working party which has been looking at this proposal. We have found this very useful and congratulate the Revenue on this open and positive approach to consultation.

4 Our contributions to the review by David Hartnett of Links with Business will be submitted under separate cover.

ANNEX A - EXEMPTION FOR GAINS AND LOSSES ON SUBSTANTIAL SHAREHOLDINGS

5 We welcome the proposals set out in Annex A of the document. We favour the proposed introduction of an exemption system rather than a deferral system.

6 We have always understood that this relief has been considered as part of a package which includes the reform of intellectual property and the changes to double taxation relief. We would welcome confirmation that the Government does not intend to introduce any further measures in addition to those above as a quid pro quo for the proposed exemption for gains on substantial shareholdings.

Definition of trading company/trading group

7 We note the proposal to adopt the definition used for capital gains tax taper relief and that the Government is prepared to consider alternatively (paragraph A.8) a definition of a trading company or a member of a trading group in terms of its activities.

8 As a general point, the capital gains tax taper relief definition is used to restrict the proposed relief to trading companies. This restriction would apply to both investing and investee companies. Whilst we understand the policy purpose behind this (but see our comment below), it is important to remember that the distinction between trading and non-trading companies is not one which is generally found in many other jurisdictions. The practical result is that if this definition is adopted, the relief will be less internationally competitive and so is less likely to encourage inward investment in the UK.

9 We also question whether there are any compelling policy reasons why the relief should not be extended to, for example, non-close investment companies as would

have been the case for the investing company in the earlier proposal for a deferral relief.

10 More specifically, there is a concern that the proposed exemption will not extend to companies or groups licensing computer software. As we understand it, the UK Government is keen to make the UK a world-wide centre for e-commerce. This ambition will be frustrated if this major new relief does not include licensing. We think the Government should ensure that such licensing is included within the exemption.

11 In summary, we favour an activities definition provided that it is so expressed as to include the intended activities of a company which is preparing to trade or has ceased trading temporarily. This definition should include certain 'investment' activities which the Government is looking to encourage, for example licensing of computer software.

12 The proposed requirement for the investing company to satisfy the trading requirement after, as well as before, the disposal in question gives us particular concern. We accept that whether relief should be given to a holding company which sells its trading subsidiaries with a view to becoming a portfolio investor is a matter of policy for the Government to decide, though to deny the exemption in these circumstances does seem to be contrary to the decision to move away from the idea of a relief which required the proceeds to be reinvested in a particular way. However we do not think it is reasonable to deny the exemption in a case where a *bona fide* trading group, which satisfies all the other requirements for exemption, decides to cease business altogether and return its funds to the shareholders, either on liquidation or otherwise. Probably this case could be satisfactorily dealt with within the terms of an "intended activities" test as proposed above. Such a test would in any case have to be drafted in a way that recognises the possibility that the company may intend to carry on no activities at all after the disposal, apart from temporary investment and subsequent distribution of the proceeds.

What is a substantial shareholding?

13 The proposed relief would only be available for shareholdings equal to or more than 20%, carrying rights to 20% or more of the income and capital. In principle, we think this threshold is reasonable and we understand the policy concern not to extend the relief to portfolio investors. However, we are concerned that relief should be available for joint venture type arrangements where the shareholding may be less than the 20% figure. We still prefer a 'hard' percentage test to a subjective test which seeks to identify joint-venture arrangements by the degree of influence exerted by the investor, but we think that consideration should be given to lowering the threshold to 10%. This is of course the internationally accepted threshold of a substantial holding for double tax relief purposes.

Other matters

Paragraph A.17 - de-grouping charge under section 179

14 The Government should take the opportunity presented by this reform to undertake a reform of section 179, TCGA 1992. Currently, when a company leaves a group

owning an asset which was acquired from another group company in the past six years, a charge will arise under section 179 on the company leaving the group. We appreciate why the charge was levied in this way, but commercially it inhibits business transactions and places potentially onerous obligations on the purchaser to undertake due diligence in respect of past transactions by the company. Whilst of course the problems can be reduced by seeking disclosure and warranties and indemnities, the charge inhibits business deals.

15 We think that consideration should now be given to the section 179 charge being levied on the vendor group. We agree with the Government's proposal that the section 179 charge should qualify for rollover relief within the vendor group, and we think that it should also be capable of being relieved against capital losses in that group as if under the provisions set out in section 171A, TCGA 1992. We think that these objectives could most simply be achieved by providing for the charge to be transferable to any company in the vendor group by a joint election between that company and the one leaving the group.

16 We appreciate that, in the event of default, the tax should be capable of being recovered from the company leaving the group.

17 This is also an opportune time to consider whether the six year look back period is too long a period. The purpose of section 179 is to prevent avoidance by transferring assets showing gains into a company which is then sold shortly afterwards for little or no gain as compared to the potential gain on the underlying assets in the company. However, as it stands the six year period catches transactions which were undertaken for commercial reasons well before the company was sold, and merely inhibits commercial deals. We think that a three year look back period would be sufficient to counter avoidance but not interfere with business decisions.

Paragraph A21 - anti-avoidance on change of residence

18 We are not persuaded that there is any major risk of companies moving their residence out of the UK in order to avoid UK corporation tax, in view of the commercial and income tax disadvantages of so doing. The main purpose of the present proposals is, after all, to make the UK an attractive location for companies. Nor, if there is such a risk, are we persuaded that the indirect approach of imposing a capital gains exit charge is the right way to deal with it. However of the four options set out, we favour the option set out in the fourth bullet point, i.e. excluding disposals of substantial shareholdings from the benefit of the exemption where they were made as part of a tax avoidance scheme. Any rule of this sort would need to be carefully targeted. In particular it would not be practicable to define 'tax avoidance' as including any transaction which reduces a UK tax liability, since a change of residence will in itself almost inevitably do that. The requirements of European law would also have to be considered.

19 However, the need to apply a 'motive' test will result in uncertainty in the application of the rules. In order to reduce the level of uncertainty, there should be a mechanism to enable a company which wishes to move its residence from the UK to obtain an advance clearance that the motive test does not apply. There will be some circumstances where the UK Revenue is protected in any event. For example, where there is a UK resident intermediate holding company which wishes to transfer shares

in subsidiaries to non EU resident companies; the transfer still requires Treasury consent under section 765(1)(d), ICTA 1988.

Other matters not referred to in Annex A

Interest relief

20 A concern has been raised that, in spite of the comments made in the document (at paragraph 2.17 - which appears to relate only to the proposals for the taxation of foreign dividends) that the Government is unlikely to see a need to introduce any restrictions on interest relief, the Revenue already has the ability to restrict relief under the loan relationships rules set out in the Finance Act 1996. Paragraph 13 of Schedule 9 to the FA 1996 denies interest relief where a company enters into a loan relationship which includes an unallowable purpose. For these purposes, an unallowable purpose includes any activity which is not within the charge to corporation tax.

21 An exemption system for corporate gains may have the result that the holdings of qualifying shareholdings in companies are not within the charge to corporation tax. Under the loan relationships rules, the result could be that loans used to finance substantial shareholdings are treated as taken out for an unallowable purpose, with the result that interest relief will be denied.

22 In view of this uncertainty, we think that an amendment should be made to paragraph 13 of Schedule 9 to put beyond doubt that this will not restrict interest relief in respect of substantial shareholdings gains from which are exempt.

Clarification of starting dates

23 We think it would be helpful to businesses if the Government would clarify when the provisions will come into force. The problem is that the proposals, whilst welcome, create uncertainty as to how business transactions should be structured. In particular, a key area of uncertainty is when the holding period for obtaining the relief will begin. If the new relief was introduced with effect from 1 April 2002, would a company which makes a disposal of a subsidiary after that date but where it had owned the subsidiary for a year before that date obtain the benefit of the exemption?

24 This uncertainty will in the short term inhibit business decision taking. Businesses need to know where they stand and we urge the Government to clarify as soon as possible how the exemption will be implemented.

25 In addition, we would welcome clarification that if a company owned 20% or more of the shares in a company for at least twelve months but which sold, say, 10% of the shares at a later date but before the introduction of the exemption system, the disposal of the remaining 10% of the shares following the introduction of the exemption within twelve months of the first disposal will qualify for the exemption.

Draft legislation

26 We hope that draft legislation will be available for comment by the end of this year so that the exemption is included in next year's Finance Bill.

ANNEX B: EXEMPTION FOR FOREIGN DIVIDENDS

27 In principle, an exemption system for foreign dividends has many attractions, not least because the exemption system is used (or there are proposals for such a system to be introduced) in many other EU countries.

28 However, we recognise the difficulties of introducing such a system, particularly given the extensive changes made to the rules for double taxation relief in the last few years and the need for this complicated new system to be given a chance to 'bed down'. We are not convinced that the upheaval caused by a move to an exemption now is, to quote the words of paragraph B.21, a 'price worth paying' and consequently we do not think that this is an appropriate time to move to a dividend exemption system.

29 However, it is important that UK tax rules remain internationally competitive and the UK Government will need to review this decision regularly in the light of international developments.

30 We have not, therefore, commented in detail on the proposed dividend exemption system set out in Annex B. In general, however, we do not favour the proposed split exemption system outlined in the consultation document, applying only to dividends from certain sources, as outlined in the document. As it stands, the proposed system set out in paragraphs 8.3 to 8.6 will be far too complicated to apply and the suggested alternatives in paragraphs 8.7 to 8.10 do not look attractive either.

31 We propose that any dividend exemption should apply to all dividends received except those dividends subject to the CFC acceptable distribution policy rules and that there should be no restriction on interest relief.

CONCLUSIONS

32 We welcome the proposed exemption for capital gains and look forward to draft legislation so that it can be implemented in 2002.

33 We think that an 'activities or intended activities' definition would be preferable to the definitions of trading company and trading groups used in the capital gains tax business asset legislation and that this could be extended to include certain activities treated as investment activities such as licensing. In principle, however, we see no reason why it should not extend to non-close investment companies.

33 The proposed 20% threshold should be lowered to 10%.

35 The opportunity should be taken to reform section 179, TCGA 1992 so that the charge falls on the vendor group but that group can also use capital losses and rollover relief against it. We also propose that the time limit is reduced from six years to three years.

36 The loan relationship rules should be amended so that interest relief will not be denied under the loan relationship rules.

37 In respect of the proposed anti-avoidance rule, there should be a clearance mechanism for any company wishing to move its residence from the UK.

38 The starting dates for the new rules should be clarified as soon as possible.

39 The Government should keep under review whether an exemption system for foreign dividends would be desirable, but we are not convinced that the split mechanism outlined the document is an appropriate method and we would prefer a general exemption subject to excluding CFC ADP dividends, with no restriction for interest relief.

40 If you have any questions on the above, please let us know.

FJH
28 September 2001
14-46-16