

# CORPORATION TAX REFORM

August 2003

## BACKGROUND NOTES

This document contains the background notes to the consultation document *Corporation tax reform*.

There are six notes, as follows.

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### **RATIONALISATION OF THE SCHEDULAR SYSTEM**

#### **Introduction**

- A.1 The August 2002 consultation document considered the case for changes to the schedular system. Under this system, a separate computation must be made of the amount of income from each source (using different sets of rules). There are restrictions on the set-off of losses from some sources against profits from other sources.
- A.2 Responses to the consultation were strongly in favour of reform, although respondents attached different priorities to the possible degrees of reform.
- A.3 Given the Government's aim of removing tax distortions wherever it is sensible to do so, there is a case for removing the schedular system entirely – the option referred to as “full pooling” below. However, responses to the consultation made it clear that a more limited reform could also deliver significant benefits.
- A.4 This background note considers two possible reforms and the issues around them. The discussion is focused on items currently treated as income, or expenditure deductible from income, for tax purposes. Capital assets are considered in Background Note C, and there is discussion in that background note of the interaction between the two strands of reform.

#### **The current position**

- A.5 The schedular system places income in several categories – income of individual trades, income from letting and so on. The main effects are as follows:
- a company must prepare a separate computation of profit for each category, and then add the amounts together. This means that, for example, a company which carries on trading and letting activities cannot simply compute a composite profit for all of its activities;
  - within each computation, the company must apply specific rules to quantify the income and the deductible expenditure, and to decide the time at which each amount should be recognised for tax purposes. Although these different sets of rules have been brought closer together in recent years, there are still significant differences;

- if the result for any one computation is a loss, there are rules determining how that loss may be relieved and these vary from category to category. The differences are set out in more detail in the table in paragraph A.18 below.

A.6 In practice, it is the third of these effects which is most significant, because it results in a lack of flexibility in the use of losses. The discussion in this background note is therefore directed primarily at this aspect of the schedular system. The impact of reform on the other two effects identified above depends on whether a “single-source” method is adopted, as discussed in paragraphs A.13 to A.16.

## Options for reform

A.7 Two possible reforms have emerged as front-runners for implementation in the short to medium term, although other options have not been ruled out. The two are:

- **Trading-letting pooling** – income and expenses (including allowable finance costs) from all trades and from letting property would be pooled. The rationale for this option is that the computational rules for trading profits and letting profits are already similar, and it is not uncommon for companies to have both types of income, so that pooling trading and letting would give rise to administrative savings. All other categories of income and their related expenses would be outside the trading-letting pool.
- **Full pooling** – all categories of income and related expenses (including management expenses) would be merged within a single pool, producing a single net result.

A.8 The implication of pooling would be that different types of income and expenditure would be combined. It would not necessarily follow that methods of computing specific amounts would change (although they might). For example, there could still be specific rules for the computation of debits and credits on loan relationships, derivative contracts and intangible assets.

A.9 The rest of this background note explores the issues which would arise in moving to one of these two systems.

## Trading-letting pooling

A.10 A trading-letting pool would encompass the profits and losses from all UK and overseas trades, lettings of property and exploitation of land within the charge to UK tax. This would extend to any miscellaneous amounts related to these activities which are currently not included in Schedule D Case I or Schedule A computations.

- A.11 The Government would welcome comments on whether to keep categories other than trading, letting and the exploitation of land separate from each other as at present, or whether to combine them in another single pool. These items would, for example, include interest not related to trading or letting and income from intangible assets not related to trading or letting.

## Full pooling

- A.12 Full pooling was the favoured option in responses to the August 2002 consultation document. It was however recognised that full pooling could have a significantly greater effect on the Exchequer than trading-letting pooling. The Government is therefore considering both options for reform, to give flexibility in managing Exchequer impact.

## Separate recognition of pooled items

- A.13 Under either trading-letting pooling or full pooling, pooled items might still be recognised separately at some stage in the preparation of a company's tax computation. In principle, two different approaches to pooling are possible:

- the **single-source method**: all of the activities to be combined could be treated as one source of income, with a profit or loss being computed in a single operation (although a company might choose to compute the results of different operations separately and then add up those results, because it chose to structure its own accounting system in that way). Thus under full pooling, there would be a single computation of profit, taking account of all income and all revenue expenses. Under trading-letting pooling, the total of trading and letting expenses would be deducted from the total of trading and letting income. This would not prevent the application of special computational rules for particular items (for example, loan relationships). Such rules could determine which amounts of income and expenditure should be taken into account, and those amounts would then be put into the single computation; and
- the **separate-sources method**: the activities which are currently regarded as separate for tax purposes could have their results computed separately, and these results could then be added together. It might be appropriate to apply the single-source method to some of these activities and the separate-sources method to others. For example, with full pooling, the results of trading and letting activities could be computed as a single source, then the results of other activities as separate sources could be calculated and finally the results from the trading-letting source and all the other sources could be added together.

- A.14 Both of these methods should arrive at broadly the same result, subject to the extent to which computational rules were aligned (and of course

the single-source method would only be practical if there were substantial alignment). Aside from the issue of alignment, the choice of approach would affect the drafting of the new legislation, and would have an impact on existing legislation. In particular, the single-source method would represent a move away from the current approach of defining sources by reference to their specific nature. It would therefore require substantial legislative change.

- A.15 Subject to the possibility of aligning the rules for management and trading expenses discussed in Background Note B and to possible changes to the capital/revenue boundary discussed in Background Note C, the Government wishes to preserve the thrust of existing rules on what incomings are taxable and what outgoings are deductible. Some of the relevant statutory rules are supported by case law, and consideration would have to be given to the best way of preserving existing case-law principles within a single-source approach.
- A.16 The Government would welcome comments on whether the single-source method or the separate-source method would be the more practical method for companies to implement, both during the transition to a reformed system and once that system was fully in place.

### **Loss relief rules**

- A.17 A revised schedular system would need a set of loss relief rules. While companies would like the greatest possible flexibility in loss relief, the impact on the Exchequer (and hence on other taxpayers, including companies which do not make tax losses) must be borne in mind.

**Current loss relief rules**

A.18 In summary, the current position on relief for the main types of loss is as follows. “Total profits” includes capital gains.

Type of loss	In-year	Previous year	Group relief (in-year only)	Carry-forward
Loss in a UK-managed trade	Against total profits	Against total profits	Allowed	Against profits of the same trade
Non-trade loan relationship deficits	Against total profits	Against non-trade interest and other non-trade loan relationship income	Allowed	Against total non-trading profits and capital gains
Loss from UK letting	Against total profits	Not allowed	Allowed if cannot use within the company	Against total profits
Loss in a trade managed overseas or from overseas letting	Not allowed	Not allowed	Not allowed	Against profits of the same trade or overseas lettings
Case VI (miscellaneous income)	Against Case VI income	Not allowed	Not allowed	Against Case VI income
Losses on intangible assets not held for a trade, property business etc	Against total profits	Not allowed	Allowed if cannot use within the company	Against total profits
Management expenses	Against total profits	Not allowed	Allowed if cannot use within the company	Against total profits

A.19 There is broad consistency in the availability of relief in the year of loss, both within the company and when losses are passed to other companies through group relief. In both cases the norm is to allow relief against total profits. There is, however, much less consistency in the availability of loss relief in the preceding year or in succeeding years.

**Possible new rules**

A.20 Scholar reform gives an opportunity to devise a more coherent set of loss relief rules, and in particular to reconsider any rules that result from historical accident and may lack a sound business case.

A.21 A possible set of loss relief rules for each option is set out below. Comments are invited on these rules, and the Government would welcome alternative suggestions.

*Trading-letting pooling*

A.22 A company could claim to set all (but not part) of a loss on the trading-letting pool against total profits of the same accounting period.

A.23 The balance of the loss could then, by an additional claim, be carried back for 12 months against total profits, taking later accounting periods first. This carry-back claim could only be made after making the current-period claim.

A.24 All or any part of a loss on the pool not used by claims under the preceding two paragraphs could be group-relieved in-year, whether or not it could have been used within the company.

A.25 Any remaining loss would be carried forward against the first available future profits in the trading-letting pool. This would be a substantial liberalisation of the current treatment of trading losses carried forward, but a small restriction of the current treatment of letting losses carried forward.

A.26 However, if what are currently chargeable gains remained as separate items, it would also be a restriction of the current treatment of letting-related non-trading loan relationship deficits carried forward. Currently, all non-trading loan relationship deficits carried forward can be set against chargeable gains. One way of addressing this issue is discussed in Background note C, paragraphs C.71 and C.72.

A.27 The existing three-year carry-back for losses in the last 12 months of a trade would be available only on the cessation of all activities within the trading-letting pool.

A.28 If items left outside the pool were not themselves pooled, they would remain subject to the existing loss relief rules for the relevant types of loss. Alternatively, if they too were to be pooled, to create a “non-trading/letting” pool, the rules currently applying to non-trading loan relationship deficits would broadly apply (with carry-back available against profits on the non-trading/letting pool).

A.29 In either case, profits on the trading-letting pool would be treated in the same way as profits from trades are currently treated, for the purposes of setting non-trading/letting losses against them. Therefore non-trading/letting loan relationship deficits would not be able to go forward against trading-letting pool profits.

A.30 Pooling of the items outside the trading-letting pool might give rise to an issue in relation to management expenses and losses on non-trading intangible assets. They can currently be carried forward

against total profits. Putting them into a non-trading/letting pool and applying the rules currently applicable to non-trading loan relationship deficits would introduce a carry-back facility which is not currently available for these items. On the other hand, it would mean denying relief against future trading or letting income. The Government would welcome views on whether this would be a serious issue in practice.

#### *Full pooling*

- A.31 A company could claim to set all (but not part) of a loss on the pool as far as possible against net capital profits of the same accounting period.
- A.32 The balance of the loss could then, by an additional claim, be carried back for 12 months against total profits, taking later accounting periods first. This carry-back claim could only be made after making the current-period claim. It would offer companies a new option to carry back excess management expenses.
- A.33 All or any part of a loss on the pool could be surrendered as group relief in-year, to the extent that:
- it could not be set against net capital profits of the same accounting period (whether or not a claim under paragraph A.31 above had been made); and
  - it had not been used by a carry-back claim under paragraph A.32 above.
- A.34 Any remaining loss would be carried forward against the first available future profits in the pool. Special considerations might apply in certain circumstances, for example in connection with controlled foreign companies.

### **Transfers and cessations of activities and transfers of companies**

- A.35 If the rules for setting off losses (for example, between different trades within the same company) became more flexible, as a result of either trading-letting pooling or full pooling, consequential issues would arise in relation to the transfer of an activity to another company under common ownership, the cessation of an activity and the transfer of a company from one group to another. These issues are likely to be more acute under the “single-source” approach, as this represents a more fundamental departure from the current system.

#### ***Transfers and cessations of activities***

- A.36 It might be appropriate to identify a proportion of losses within a pool that related to a specific activity. These losses could be transferred to another company in common ownership, if the activity itself were

transferred, or extinguished on the cessation of an activity. Apportionments are not necessary at the moment (except when parts of trades are involved), because losses relating to separate activities are carried forward separately.

- A.37 Any such apportionments might have to be on the basis of “such apportionments as may be just” which is currently used on the transfer of part of a trade to another company in common ownership.
- A.38 Alternatively, there could be a rule that losses would always stay with the company in which they arose, and would continue to be carried forward in that company’s pool (subject to the need to prevent the sale of companies or transfers of activities in order to use tax losses – see below).
- A.39 This would have the merit of simplicity, but it might inhibit corporate re-organisations which involved taking potentially profitable activities away from companies which were carrying losses forward, because the probability of the losses going unused would be increased.

#### ***Change of ownership of companies***

- A.40 The Government does not intend to relax the present rules where companies are bought and sold for their losses or their capacity to absorb losses.
- A.41 The main rule affects trading losses. When it applies, it prevents the carry-forward of trading losses from before a change in ownership of a company to set against profits arising after the change in ownership. Correspondingly, trading losses arising after a change in ownership of a company cannot be carried back and set against profits arising before the change in ownership. The rule applies when there has been a major change in the nature or conduct of a trade within three years before or three years after the change in ownership. It also applies when a trade became small or negligible and was not revived before the change in ownership. There are similar provisions for other types of loss (including losses on letting businesses), and for excess management expenses, though they are triggered in slightly different ways.
- A.42 The main rules referred to above operate by reference to changes in a trade, but following schedular reform, the results of individual trades might not routinely be identified separately for tax purposes. The rules might therefore need to be re-written.
- A.43 The rules might come under more pressure because trading losses carried forward would no longer be restricted to relief against future profits from the same trade. This would make the preservation of losses carried forward more valuable because it would create scope to inject profitable activities into a company to absorb the losses. The

transfer of losses between group companies in periods later than the period of loss would also become easier.

- A.44 A stricter rule might therefore be appropriate. It would be possible to have a lower threshold for triggering loss-buying rules, and possibly even to trigger them on all changes in ownership. The goal here would not be to block all carry-forward of losses through all changes of ownership, but rather to ensure that the reformed system did not provide scope for abuse of losses in the way described above.
- A.45 Correspondingly, there would be a case for changing the restrictions on carrying losses back through a change in ownership.
- A.46 It would also be necessary to consider consequential changes to other legislation that referred to specific trades.

### **Loss relief – transitional arrangements**

- A.47 To the extent that schedular reform freed up the use of losses, arrangements would be needed for losses brought forward from before the introduction of reform (“pre-commencement” losses). Under full pooling, immediate application of the post-schedular reform rules to the accumulated pre-commencement losses might have a substantial impact on the Exchequer. Responses to the August 2002 consultation document made it clear that companies favoured a short and simple transition, but also that companies did not want to lose the benefit of pre-commencement losses.
- A.48 There are many ways in which a balance might be achieved between controlling the impact on the Exchequer and preserving companies’ expectations about the use of pre-commencement losses. The Government will consider carefully the position of companies which start in business shortly before commencement, and accrue initial losses before coming into profit.
- A.49 The Government would welcome comments on the following possible approaches, and on any others which respondents may wish to suggest:
- companies could be required to apply existing rules to pre-commencement losses;
  - existing rules could apply to pre-commencement losses, but companies (or, where applicable, groups of companies) could elect once and for all to forgo a certain proportion of those losses in exchange for having the balance treated as though they were post-commencement losses. It is envisaged that such an election would be made by companies or groups which had only modest pre-commencement losses remaining, and which would prefer to be free of the old rules;

- pre-commencement losses would be capable of being set against the same range of profits as post-commencement losses, but only a certain proportion of pre-commencement losses could be used in any one year, with the balance having to be carried forward for use in later years.

## **Other consequential issues**

### ***Pre-trading and pre-letting expenditure***

- A.50 Under either of the two forms of pooling mentioned above, separate trades and a separate letting business would no longer be routinely identified if the single-source method were applied. This might make it harder to identify pre-trading or pre-letting expenditure.
- A.51 One possibility would be to treat expenditure which is currently identified as pre-trading or pre-letting just like expenditure incurred while a trade or a letting business was being carried on. However, immediate relief for expenditure incurred many years before a trade or letting business commenced might give relief for expenditure where there was no prospect of that expenditure leading to taxable profits, or no prospect for many years. It might therefore be appropriate to retain some restriction, to the effect that expenditure was not allowable until some related activity had commenced.

### ***Overseas income***

- A.52 Any new system would need to allow double taxation relief to be computed correctly. The relevant amount of income and of UK tax would have to be identified. The attribution of loss relief to particular profits would also need to be considered. Comments on ways of achieving an appropriate result would be welcome.

### ***Non-residents***

- A.53 The corporation tax charge on non-resident companies applies where a company carries on a trade through a permanent establishment in the UK. Under schedular reform, the tax system might no longer routinely identify individual trades. It might be necessary to continue to identify separate trades for this purpose.
- A.54 It might also be appropriate to consider the scope of the corporation tax charge as it relates to non-resident companies. This would have to be done in a way that took account of the UK's bilateral tax treaties and preserved the existing rules for non-residents acting through investment managers in the UK.

### ***Shareholder investment incentives***

- A.55 The conditions of eligibility for the Enterprise Investment Scheme (EIS), the Venture Capital Trust Scheme (VCT) and the Corporate Venturing

Scheme (CVS) include a requirement to invest in companies which carry on qualifying trades. Enterprise Management Incentives (EMIs) are also only available to companies carrying on qualifying trades. While schedular reform might lead to separate trades no longer being routinely identified for tax purposes, the Government does not foresee difficulties in applying the existing rules for the purposes of these schemes and incentives.

### ***Mutual business***

- A.56 Either of the two forms of schedular reform considered here, if implemented using the single-source method, might make it difficult to maintain the current limitation of mutual business treatment to trading activities and the exclusion of letting activities. The reason is that the boundary between trading and letting would no longer routinely be drawn.
- A.57 The Government would welcome views on how best to address this. It would be possible to continue to identify trades for this specific purpose, in order to preserve the current position. But the results of the activities which fell outside the scope of the mutual trades would then have to be computed if a company was carrying on any activities other than mutual trading. This would represent a move away from the general pattern of schedular reform.

### ***Non-commercial activities***

- A.58 Loss reliefs for non-commercial activities, and for farming and market gardening which give rise to losses in several consecutive years, are currently restricted. Following schedular reform, separate activities within a pool would no longer be routinely identified for tax purposes if the single-source method were applied. It would however still be necessary to identify any non-commercial activities and farming or market gardening activities, together with all of their associated expenses, so that loss reliefs could continue to be restricted.

## **Specific sectoral regimes**

### ***Life assurance***

- A.59 Life assurance is subject to a special tax regime, the “I minus E” regime, under which parts of the business are taxed as if they were not trading activities. The current charge takes the income arising under Schedule A and Cases III, V and VI of Schedule D. It gives relief for expenses as management expenses and for loan relationship debits, net of credits, as non-trading deficits. This regime may change as a result of various pressures on the system, but even if it did it is likely that transitional measures would retain the “I minus E” system for existing business for many years.

- A.60 Schedular reform of either type would necessitate some changes. If trading and letting profits were pooled, it would be necessary to carve out those letting activities of a life assurance company which provided an investment return to policyholders, so that those activities could be included in the non-trading/letting activities within “I” in the “I minus E” system. Under full pooling, particularly if the single-source approach were adopted, the basic rules of the “I minus E” system would have to be rewritten to some extent, probably along the lines of previous New Zealand or Australian legislation. Both countries have had an “I minus E” system but not a schedular system.
- A.61 Schedular reform might also make it appropriate to reduce the number of different categories of business which currently exist. For example, there might be just two classes, one for business where the returns to both the insurer and policyholders are taxed together (basic life assurance and general annuity business – BLAGAB) and the other for business where only the profit made by the insurer is taxed on the company (pension, ISA, life reinsurance, overseas life assurance business and possibly permanent health insurance business). This would, among other things, mean the end of the complex rules for overseas life assurance business (though it might be desirable to retain some broad asset allocation rules for currency denominated assets and liabilities). And it would allow losses of one category to be set against profits of another category.

### ***North Sea trades***

- A.62 North Sea (and other UK Continental Shelf) oil and gas extraction trades are currently within a corporation tax ring fence, and a 10% supplementary charge applies to profits arising within the ring fence.
- A.63 The Government does not intend to alter this basic position. This means that it will not be possible to include a trade within the ring fence in any wider pool. The current rules that allow losses to come out from the ring fence and be set against non-ring fence profits are likely to be maintained. Any such losses would be subject to the rules on loss relief applying to the pool which included non-ring-fence trades.
- A.64 It is proposed to treat non-ring-fence upstream trades (oil and gas extraction outside the North Sea) like other trades. They would therefore enter into any pool of trades and other activities created by schedular reform.

### **Points on which the government requests comments**

- A.65 The Government would welcome views generally on the ideas discussed in this background note and specifically on the following points:

### ***Types of pooling***

- What would be the extent of the benefits delivered by full pooling?
- What would be the extent of benefits delivered by pooling all sources of trading income and income from property?
- Would there be disadvantages in either form of pooling, or any difficulties in implementation?
- Should the scope of trading-letting pooling be as defined in this background note, or should the boundaries of the pool be changed?
- Would it be better to combine items outside the trading-letting pool into a single pool, or to keep them in their current separate categories?

### ***Loss relief***

- What loss relief rules would be appropriate for each type of schedular reform?
- If relief for pre-commencement losses had to be limited, what would be the best way of doing so?
- On the transfer of an activity to another company in common ownership, would it be better to identify a proportion of losses within a pool to transfer or to leave losses with the original company? If the former, how could the proportion of losses best be computed?
- What treatment of losses would be appropriate on a change in ownership of a company?

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

- How should pre-trading and pre-letting expenditure be treated?
- What would be the most appropriate approach to double taxation relief computations?

### ***Specific types of business***

- How, if at all, should conditions for shareholder investment incentives be amended to preserve their broad effect following schedular reform?
- How should mutual business be treated?
- In what ways, if any, should schedular reform affect the treatment of life assurance?

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

### ***Administrative costs and savings***

- What would be the likely compliance cost savings to companies from trading-letting pooling and from full pooling?
- How would these savings affect small, medium and large companies differently?
- How would sectoral issues affect the savings?
- Would the schedular reform proposals reduce the amount of record-keeping that companies had to do, and what savings would follow from this?
- Would any of the possible changes to the schedular system produce any ongoing additional compliance costs for companies? How?
- Would changes to the schedular system produce any one-off costs relating to restructuring activity? How?

## BACKGROUND NOTE B

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### THE TAX DIFFERENCES BETWEEN TRADING COMPANIES AND INVESTMENT COMPANIES

#### Introduction

- B.1 Chapter 5 of the August 2002 consultation document discussed how the current corporation tax regime differentiates between trading companies and investment companies. Some of the differences have developed unintentionally, others by design.
- B.2 The tax effects of the distinctions between trading and investment companies are that:
- corporate profits are computed differently for trading and investment companies;
  - the reliefs available to trading companies and their shareholders differ from those available to investment companies and their shareholders.

#### *Computational differences*

- B.3 The tax computation of trading profits starts from accounting profits prepared according to UK generally accepted accounting practice, subject to any overriding statutory or case-law principles (including those in section 74 of the Taxes Act, which prevent certain items of expenditure from being deducted). These rules apply generally to any company carrying on a trade, so that trading expenses charged in the profit and loss account will be deductible unless they are expressly disallowed.
- B.4 The rules governing the deductibility of the expenses of managing investments differ from those relating to trading deductions in at least two respects:
- they do not take the accounts as a starting point – rather, expenses are deductible if they fall within the specific rules in section 75 of the Taxes Act, which requires expenses to have been “disbursed for that period”; and
  - amounts are deductible as management expenses only if the company qualifies as an investment company – that is, if the company’s business consists wholly or mainly in the making of investments and the principal part of its income is derived from them.

### ***Differences for reliefs***

- B.5 Distinctions based on the type of activity undertaken by a company have been drawn in many places in the UK tax system. In some cases this is because tax measures have been targeted at particular activities or at particular classes of company, either for specific policy reasons or as a defence against avoidance.
- B.6 The areas in which the trading/investment distinction arises include: company reconstruction legislation, exemption for gains on substantial shareholdings, roll-over relief, demergers legislation, purchase of own shares provisions, venture capital reliefs (CVS, EIS, VCTs), enterprise management incentives, hold-over relief, loss relief to shareholders and lenders and business assets taper relief.

### **Comments received on the current system**

- B.7 Respondents to the August 2002 consultation document welcomed the opportunity to review these differences. Many felt that the trading/investment distinction is out of date and an unnecessary complication in the corporation tax system. A common theme in responses was that the number of boundaries in the corporation tax system should be kept to a minimum.
- B.8 The reform that most would like to see is the extension of entitlement to relief for the expenses of managing investments. The fact that relief for the expenses of managing investments is restricted to investment companies (whereas all companies with trading income can get relief for trading expenses) produces an artificial segregation of business activities. This can lead to a proliferation of companies within groups, created and retained purely for tax reasons. Respondents commented that the two expenses regimes increase compliance work and administration costs for companies.
- B.9 There was a clear message in the responses to the August 2002 consultation document that companies do not like the uncertainty resulting from the current regime. Companies and groups spend time and money considering whether a company will qualify as an investment company and therefore be entitled to relief for management expenses. Groups may also have to re-structure in order to ensure that these expenses arise in a company which will qualify.
- B.10 Some have commented that these uncertainties reduce the attractiveness of the UK as a location for their group holding companies.
- B.11 Another concern raised in the consultation was that some companies do not fall neatly into the current trading or investment categories. For example, a company that carries on a trade might also carry on an investment activity or act as the holding company of a group or a sub-group. Due to its trade, such a company may not qualify as an

investment company, and may therefore be unable to get relief for the expenses of managing its investments. Current corporation tax legislation does not cater for these “hybrid” companies.

- B.12 The rule for the timing of management expenses (“any sums disbursed as expenses of management ... for that period”) is a further source of uncertainty. This is sometimes out of line with the way in which expenditure is debited in accounts and with the timing of relief for trading expenses. While in practice any problems may be resolved by a sensible and pragmatic approach, respondents felt it would be preferable to put the position on a firmer statutory basis.
- B.13 Another area of uncertainty is the extent to which the principles of deductibility for trading expenses carry over to the context of management expenses. The management expenses regime was originally introduced to remove the disadvantage that investment companies had suffered in not being able to deduct the expenses of managing their investments, and the Revenue view is that the intention was not to allow them wider reliefs than those available to trading companies. But it is acknowledged that this view is not universally accepted.
- B.14 In addition to the rules governing the deduction of expenditure, the following areas were seen by respondents as priorities for possible reform:
- the extension of substantial shareholdings exemption to investment companies;
  - the extension of roll-over reliefs to investment property.
- B.15 The responses also acknowledged the significant read-across to possible reforms relating to the schedular system and the taxation of capital assets. These reforms are covered in background notes A and C respectively.

## **The way forward**

- B.16 Some differences between the treatment of trading and investment companies have been justified historically on the grounds that trading activity needs greater support because of its inherently riskier nature and because of its direct contribution to productivity and economic output. However, this argument does not necessarily constitute grounds for different tax treatment between trading and investment companies. Typically, the assets held by investment companies are factors of production of trading companies. Investment companies may perform an important economic role, for example by providing rented commercial property as an alternative to ownership by the occupier, or by gathering and managing investment funds for use as financial capital in productive businesses.

- B.17 On the basis of the economic case, the Government has some sympathy with the view that the traditional distinction between trading and investment should be examined critically, when it is relevant, in the introduction of new reliefs or other provisions. However, it has to be recognised that economic arguments might not be the only factor. In some cases, the scope for avoidance and loss of tax might be greater if there were no distinction, given the different nature of investment activity.
- B.18 The Government is also prepared to examine existing legislation to consider whether the differences that are present should survive. However, this will need to be done on a case by case basis. There may well be good reasons why the existing approach remains valid and appropriate. It will also be necessary to adopt a staged approach, focusing first on the most important areas. The Government is therefore grateful that, in responses to the August 2002 consultation document, business identified its priorities in this area.
- B.19 In this next round of consultation, the Government proposes to focus on the issue which emerged as a particular priority from the first round: the different expenses regimes for investment companies and trading companies. Responses indicated that business attaches considerable importance to reforms in this area and they would represent a significant step towards streamlining the computation of companies' taxable profits.
- B.20 The Government is also considering two other areas that have been identified by business as of particular importance:
- the possible extension of the substantial shareholdings exemption to disposals by shareholding companies that are investment companies; and
  - the possible extension of roll-over relief beyond its present scope.
- B.21 Possible changes to the expenses regimes and the possible extension of the substantial shareholdings exemption are discussed further in the remainder of this background note. Roll-over relief is explored in Background Note C alongside the proposals for the taxation of capital assets.

### ***Personal investment companies***

- B.22 The existing close investment-holding company rules serve to ensure that close investment-holding companies (broadly, close companies other than those engaged wholly or mainly in commercial trading or letting activities) always pay tax at the main rate of corporation tax. The Government is committed to retaining this rule, which serves to prevent individuals from gaining an unfair advantage by placing their personal investments into a corporate wrapper, in order to benefit from the lower rates of corporation tax.

## Expenses deduction regimes

### *Historical foundations*

B.23 The differences between the allowable deductions of expenses for trading and investment companies can be traced back to before 1915 when the definition of an investment company and the management expenses rules were introduced. The original purpose of these rules was to allow relief for business expenses for investment companies that would not otherwise have been relieved, because expenses were not generally deductible in computing income from investment sources. The objective was to give relief for expenses of managing investments of investment companies on a broadly similar footing to expenses of trading companies.

### *Possible changes*

B.24 The Government is considering changes to the management expenses regime to:

- remove the requirement for a company to qualify as an investment company in order to obtain relief for the expenses of managing its investments; and
- align the rules governing the deduction of management expenses more closely with their accounting treatment – for example, by following the accounts in relation to the timing of the deduction.

B.25 The first of these changes would put all companies onto a level playing field in terms of entitlement to relief for the expenses of managing their investments, and would remove the difficulties associated with hybrid companies. It would increase certainty for companies, would remove the need for groups to take steps to ensure that management expenses fall within a company qualifying for relief, and would facilitate group re-structuring.

B.26 The second change would streamline and simplify the computation of taxable profits, and would improve transparency and certainty. It would also make the management expenses rules more consistent with those for trading expenses.

### *A “business expenses” rule?*

B.27 Several respondents to the August 2002 consultation document indicated that a single expenses rule, covering expenses related to a company’s business as a whole, might be an attractive goal. This approach would require the identification of existing case-law principles of continuing importance and consideration of how best to retain their effect. For example, it would be necessary to consider how best to deal with expenses which the courts have held to be inadmissible on

the grounds that they were incurred for purposes other than earning profits.

- B.28 The Government recognises that this might be a logical development, consistent with the objective of providing a comprehensive regime for the relief of expenditure. It would, however, represent a significant step further than the changes identified above as a priority for reform.
- B.29 The scope of any such rule would depend on the extent and nature of schedular reform discussed in Background Note A and possibly also on the changes proposed in Background Note C. Such a change could also have significant implications in terms of Exchequer cost.
- B.30 While the Government welcomes views on the possibility of moving to a general business expense rule, and on the form that such a rule might take, such a move is likely to be a longer-term goal rather than a priority to be taken forward as part of the current round of reform.

### ***Life assurance***

- B.31 In taking forward any reform of management expenses, special consideration will need to be given to the position of life assurance companies, taxed on the "I minus E" basis. Comments are invited on how and with what modifications the special rules for management expenses of insurance companies might be included in any general changes to the management expenses regime.

### ***Other mutual businesses***

- B.32 Special consideration would also have to be given to mutual businesses, the surplus from whose trading activities is currently not subject to tax. If relief for the expenses of managing investments were available to companies generally, it would be necessary to ensure an appropriate allocation of the company's total expenses. So, for example, expenses which would have been deductible in computing trading profits, had they been taxable, would not be allowable as management expenses.

## **Substantial shareholdings**

### ***The exemption***

- B.33 Legislation in Finance Act 2002 provided exemption from corporation tax on chargeable gains arising on disposals by some companies of substantial shareholdings in other companies. The exemption applies to holdings of 10% or above of another company's ordinary shares (or, within certain conditions, assets related to shares). There is a restriction on the exemption, in that both the shareholding company and the company in which the shares are held must be trading companies or members of a trading group (in the case of the shareholding company) or the holding company of a trading group or

trading sub-group (in the case of the company in which the shares are held). There are other conditions, for example, requirements that the shares should be held for a certain period of time.

- B.34 Some of the responses to the August 2002 consultation document made the point that an extension of the substantial shareholdings exemption to companies or groups which are not within the definition of trading companies/groups might be consistent with proposals to review the differences between the tax treatment of trading companies and investment companies.

### ***The shareholding company***

- B.35 As a counterpart to the extension of entitlement to management expenses, the Government will consider removing the restriction on the substantial shareholdings exemption at the level of the shareholding company. This would extend the scope of the exemption to shareholding companies that are investment companies or companies within a group that is not a trading group. Removing the restriction would make it easier for companies to tell whether they qualified for the exemption.

- B.36 However, the Government believes that allowing all investment companies to benefit from the exemption would create distortions and might permit the avoidance of personal liability to capital gains tax in some cases. So the Government does not intend that the exemption should be extended to companies which exist solely for the purpose of “wrapping up” personal stakes in trading companies to get the benefit of the exemption. Disposals of such personal holdings are already in most cases eligible for business assets taper relief. The Government is therefore considering a provision to continue to exclude shareholding companies which are close investment-holding companies (broadly, close companies other than those engaged wholly or mainly in commercial trading or letting activities) from the scope of the exemption.

### ***The investee company***

- B.37 At present, the Government does not favour the removal of the trading company restriction for the company in which the shares are held. Essentially, the reasons for including the trading restriction on the investee company in the Finance Act 2002 legislation still apply. First, exempting disposals of holdings in non-trading companies could allow a shareholding company to avoid a charge on profits on underlying assets, which would otherwise be taxed, simply by wrapping those assets up in another company. Sales of shares in that company would be exempt as long as the holding exceeded the 10% threshold. This would essentially enable the shareholding company to avoid having to pay tax on the full economic profit of the increase in the value of the underlying assets.

- B.38 Second, removing the trading restriction on the investee company would provide a greater incentive for “income into capital” avoidance. This is already a cause for concern under the existing chargeable gains legislation. A shareholding company could in certain circumstances use a holding in another company to shelter income, to build up a moneybox tax-free and then sell the shares under the exemption. Allowing income to accumulate in an overseas company where the holding exceeds 10%, without the payment of dividends, and then selling the company under the exemption is one variation on this practice.
- B.39 The Government sees the trading restriction on the investee company as the best protection available at the moment against these avoidance possibilities. The Government will keep the substantial shareholdings exemption under review but sees no case at the moment for extending the exemption to non-trading investee companies.

### **Shareholder and other reliefs**

- B.40 In addition to the trading company restrictions within the substantial shareholdings legislation there are some statutory provisions that, as a result of policy design, give trading companies more favourable treatment than investment companies. This wide range of reliefs includes provisions on demergers and purchase of own shares, consortium relief, venture capital reliefs (CVS, EIS, VCTs), enterprise management incentives, hold-over relief, loss relief for shareholders and business assets taper relief. Where there is a strong policy rationale for the current restrictions, the distinction is likely to remain.
- B.41 Several commented on these differences but their concerns were secondary compared with the alignment of expense deductions for trading companies and investment companies. The Government may, over the longer term, review the range of differences between the treatment of trading companies and investment companies. If it does this it will review the policy rationale behind the current differences, including the avoidance implications of removing any restrictions on relief, and will consider whether the original policy reasons for each distinction are still valid.

### **Points on which the Government requests comments**

- B.42 The Government would welcome views generally on the ideas discussed in this background note and specifically on the following questions:

#### ***Expenses rules***

- Comments are invited on the possible removal of the requirement to qualify as an investment company in order to obtain relief for the expenses

of managing investments. To what extent would group re-structuring be facilitated by such a change?

- Comments are invited on the possible closer alignment of the management expenses rules with the accounting treatment (for example, by following the accounts in relation to the timing of the deduction). Would there be any disadvantages in such a change?
- What would be the practical effects of these changes for companies?
- How would the changes affect different sectors and sizes of company?
- Do respondents see any issues arising from the interaction between these changes and the proposed reforms of the schedular system and the taxation of capital assets?
- Comments are also invited on the idea of a single business expenses rule. What would be the preferred form of such a rule?
- What modifications to the special rules for management expenses of insurance companies might be included in any general changes to the management expenses regime?

### ***Substantial shareholdings exemption***

- What would be the benefits of the possible extension of the substantial shareholdings exemption to shareholder companies that are investment companies? Would there be any disadvantages?
- Comments are invited on the Government's view that avoidance concerns would make the extension of the exemption to non-trading investee companies too risky.
- Are there other aspects of the exemption which you think the Government should examine in the context of corporation tax reform?

### ***Other issues***

- Looking towards the future, which other shareholder reliefs would business identify as a priority for review (assuming that the current distinction was no longer required for Exchequer protection)? What would be the likely effect on business of removing the distinction in these areas?
- What new anti-avoidance provisions would respondents be prepared to see introduced in order to facilitate such changes?

### ***Administrative costs and savings***

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

- How would these administrative cost savings affect small, medium sized and large companies differently?
- How would sectoral issues affect the administrative cost savings?
- What would be the likely administrative cost savings from the removal of the substantial shareholdings exemption trading restriction at the level of the shareholding company?

## BACKGROUND NOTE C

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### THE TAXATION OF CAPITAL ASSETS

#### Introduction

C.1 The August 2002 consultation document set out ways in which assets subject to the chargeable gains legislation for companies could be moved into an income regime. The introduction of new regimes dealing with taxation of foreign exchange, financial instruments, and loan relationships in 1993, 1994 and 1996 started a process of aligning tax treatment more closely with the accounting treatment. Finance Act 2002 continued this with the regime for intangible assets, modifications to the loan relationships regime and the introduction of the derivative contracts regime. These changes mean that the chargeable gains rules now apply only to a limited range of assets including:

- land and buildings;
- financial assets not within the derivatives contracts or loan relationships regimes;
- other tangible fixed assets (mainly plant and machinery); and
- intangible assets acquired or created prior to 1 April 2002.

C.2 The August 2002 consultation document proposed that the tax treatment of capital assets should align more closely with commercial results where there was a firm basis to do so. This might include:

- taxing or relieving all profits and losses on the basis of the amounts recognised in the accounts, whether this was on a fair value, accruals or realisation basis;
- giving relief for commercial depreciation on assets according to the amounts recognised in the company's accounts; and
- the abolition of indexation relief, at least for periods after the commencement date.

C.3 The responses to the proposals in the consultation document were mixed:

- there was concern that the proposals might lead to the taxation of unrealised gains on investment properties;

- there was a good deal of support for the retention of some form of roll-over relief on the sale of capital assets and some favoured extending the scope of the current relief;
- there was support for retaining indexation relief although some were willing to forgo future indexation as part of a balanced package of reforms;
- there was a mixed response to the replacement of capital allowances by commercial depreciation, reflecting the wide range of assets that would be affected and the disparities between their current and proposed treatment. It was recognised that capital allowances accelerated relief in the case of some assets;
- there was considerable concern about the complexities that would be introduced by any transitional provisions; and
- many respondents were concerned that a “follow the accounts” approach might give results that they would find unacceptable for tax purposes without further adjustments to the accounts figures.

C.4 The range of responses reflects the variety of reliefs and allowances available in the current corporation tax regime. Many who responded could identify an aspect of the regime that was advantageous to their company, while at the same time identifying an aspect that they considered inequitable. And there was a natural tendency for respondents to be heavily influenced by the implications for their companies.

## **The way forward**

C.5 In taking forward this strand of reform, the Government’s strategy continues to be to move to a more coherent system which taxes profits more comprehensively and, as far as possible, to reduce the inconsistencies which can lead to distortions within the current regime between:

- capital and income profits;
- different categories of asset (for example, plant and machinery as compared with buildings); and
- similar assets used in different contexts (for example, investment property as compared with owner-occupied property).

C.6 To achieve these objectives, the Government remains attracted to the approach of using the commercial accounts as the starting point across a wider range of the corporate tax regime. Such a move would effectively replace the chargeable gains regime for companies. However, the Government recognises that adjustments to the accounts

will be required in certain circumstances, and the issues that arise are discussed in more detail in the remainder of this background note.

- C.7 This background note illustrates how the regime might work by considering the possible treatment of particular types of asset: land and buildings, plant and machinery and shares. Certain features of the new regime, however, are common across all asset types and these will be discussed first.

### ***Indexation relief***

- C.8 One of the principal differences between the taxation of income and capital profits in the present system is the availability of indexation relief in computing chargeable gains. This inconsistency in the taxation of capital as opposed to income profits introduces a distortion favouring investment in assets which generate gains as opposed to income.
- C.9 While the Government acknowledges that, historically, indexation relief has recognised an earlier period of high inflation and has been valued by those holding assets for the long term, it considers that the relief has a diminishing significance in the current stable macroeconomic climate. As part of a balanced package of measures, moving towards a more comprehensive and coherent regime for dealing with capital expenditure and taxing capital profits, it is envisaged that indexation relief will no longer be available on profits accruing within the new regime.
- C.10 There are a number of different options for transition to the new regime, discussed in more detail in paragraphs C.74 to C.85 below. These options would bring indexation to an end in somewhat different ways. However, all would preserve indexation accrued up to commencement of the new regime.

### ***More comprehensive relief for capital expenditure***

- C.11 The corollary of moving towards a more comprehensive regime for taxing capital profits is the provision of a more comprehensive system of relief for capital expenditure. One aspect of this is the availability of relief (either based on commercial depreciation or at a specified rate) for certain types of capital expenditure which do not currently qualify for capital allowances. This is discussed further in the section below on land and buildings (paragraphs C.17 to C.34).
- C.12 Another aspect is availability of relief for capital expenditure which either does not produce a capital asset or is not reflected in the state of the asset at the time of disposal. Such expenditure currently finds no relief within the chargeable gains regime. On the other hand, such expenditure is relieved within the new comprehensive income regime for the taxation of intangible assets, based broadly on the accounting treatment. Extending this kind of regime to assets currently in the

chargeable gains regime would achieve a similar result across the board.

### ***Tax treatment of disposal proceeds***

C.13 The current chargeable gains regime has little regard for the way in which transactions are represented in the accounts of a company. If the new regime is to take as its starting point the commercial accounts of the company, this may result in changes to the timing of the recognition of profits on disposal. Where, for instance, an asset is sold for an unascertainable deferred sum the accounts may not recognise the right to receive future sums in the accounting period of the disposal. If the accounts are used as a starting point for the computation of capital profits it may be that the profit is likewise brought into account in periods after the disposal. This is an issue which will be considered as the proposals relating to specific types of asset develop.

### ***Transactions between related parties***

C.14 Special rules might be required to deal with transfers of assets between related parties, including transfers within a group. These issues will be considered as the proposals set out in this background note develop.

### ***Interaction with other areas of taxation***

C.15 Changes in the taxation of capital assets will require changes in other areas of taxation. For example the loan relationships rules, which tax all profits on debt instruments as income, exclude loans from the regime where the return on the lending is closely linked to the value of certain capital assets and some loans convertible into shares. In these cases part of the return on the debt is more akin to the return on an investment in a capital asset and is taxed accordingly. Where these reforms cause the taxation of the capital asset to be indistinguishable from an income treatment, it would be appropriate to bring the convertible or asset-linked debt entirely within the loan relationships regime.

C.16 Similarly, in cases where a derivative is currently excluded from the derivatives contracts regime because the underlying asset is a capital asset subject to the chargeable gains regime, the scope of the derivatives regime would need to be changed to reflect the inclusion of the underlying asset in an income regime, with some consequential simplifications.

## **Land and buildings**

C.17 Respondents to the August 2002 consultation document argued that there are inconsistencies in the current tax treatment of property.

Depending on the capacity in which a company holds a property and the use to which it is put, a variety of reliefs and allowances are available, including:

- roll-over relief on replacement of business assets;
- Industrial Buildings Allowance (IBA) – broadly, an allowance given over 25 years for the costs of constructing an industrial building;
- Agricultural Buildings Allowance (ABA) – an allowance similar to IBA but applying to agricultural buildings.

C.18 A factory held by a trading company and used in the company's trade might attract IBA and when sold any gain could, subject to detailed rules, be rolled over into the purchase of a new factory. An investment company holding the same factory, and letting it to a trading company, would not get the benefit of rolling over the gain on disposal.

C.19 The August 2002 consultation document set out an option that tax should follow the accounts. In broad terms such an approach might mean that the commercial profit recorded in the accounts would equate to the profit charged to tax. Thus tax would be charged on revaluations to the extent that they appeared in the profit and loss account and relief would be given for depreciation and impairments as charged in the accounts.

C.20 If a company adopts International Accounting Standards (IAS) in this area, the accounting treatment will depend on the context in which the real property is used or held. Revaluations of investment property are likely to be taken to the profit and loss account under IAS 40, while any revaluations of property used in the business (IAS 16) are likely to be taken to reserves. Impairments of all types of property will usually be taken to the profit and loss account. If the tax treatment were to follow the requirements of section 42 Finance Act 1998 by taking the figures only from the profit and loss account, investment companies might see their revaluations taxed while owner-occupiers might not. The tax treatment could therefore vary depending on the ownership of the property even though its use was the same in both cases.

C.21 A further source of difficulty here is the possible change to the concept of "profit and loss account". A joint project between the Accounting Standards Board (the ASB) and the International Accounting Standards Board (the IASB) is in the process of developing a comprehensive income statement which would combine the current profit and loss account and the statement of recognised gains and losses (the STRGL). Many of those who responded to the August 2002 consultation document were wary of welcoming a move towards following the accounting treatment of real property while accounting standards are in a state of flux. The Government will continue to monitor the developments in accounting standards in taking forward these reforms.

- C.22 There are good economic grounds for moving towards the taxation of revaluation reserves. The wealth of a company owning an appreciating property increases year by year but this increase in wealth remains untaxed. By contrast, if the company has financed the purchase of the property through borrowing, the costs of borrowing may be an allowable expense for tax purposes. This tax treatment can be an incentive to a company to hold on to property when it might otherwise be more appropriate to sell and put its capital to use in some other way.
- C.23 However, the Government also recognises that taxing investment properties on the basis of the accounting entries would raise practical difficulties where a fair value basis was adopted. Charging tax on unrealised gains on a relatively illiquid asset such as property could create cash-flow problems for companies, and establishing acceptable valuations might cause difficulties. These considerations are not so relevant where liquid financial assets are concerned.
- C.24 To address the practical difficulties of taxing an unrealised gain it might be possible to charge tax by reference to revaluations taken to profit and loss but defer payment of the tax charged until a disposal took place. Such a measure would mean that the taxation of real property could follow the accounts without imposing payment of tax on unrealised gains.
- C.25 The alternative to following the accounts and taxing changes in value of the asset is to tax capital profits on a realisation basis. This approach would use the accounting entries as a starting point, but computational adjustments would be made to exclude unrealised gains from taxable profits.

### ***Reliefs and allowances***

- C.26 The tax treatment of expenditure on property and the taxation of profits from the sale of buildings are areas where tax may distort commercial decisions. The context in which property is held determines the allowances that may be available for expenditure and the reliefs that may be available to defer the tax charge on disposal. It is undesirable for the tax system to encourage companies to structure their property holdings in particular ways when commercially they might not be the most efficient ways of operating, or to encourage companies to hold on to properties when commercially it would be more appropriate to sell.
- C.27 The cost of acquiring a property is incurred at the outset but currently no relief is given until disposal except in certain cases such as industrial buildings and agricultural buildings which qualify for IBA or ABA. These allowances offer relief over 25 years based on the original cost of construction of the building. Where expenditure on a property does not attract these allowances (for example, expenditure on commercial buildings), no relief is given for the expenditure until the cost is deducted in computing a gain on disposal. In order to remove

this distortion it might be appropriate to allow some form of general relief for expenditure on buildings over their period of use, either on the basis of the accounting entries or as a fixed rate allowance.

- C.28 One option would be to use the accounting entries as the basis for allowances.
- C.29 This method would allow depreciation when it was debited in the accounts. This method has the apparent advantage of simplicity, but it might give an uneven result over the spectrum of property ownership. For example, under IAS, when a building is acquired, the way the building is exploited by its owner will determine the accounting treatment. Properties held as investments are unlikely to be depreciated annually, whereas owner-occupied properties are more likely to show an accounts charge for depreciation.
- C.30 An alternative option would be to have a fixed-rate allowance, calculated by reference to expenditure on acquiring an asset, which would not distinguish between the different contexts in which the building was held and used.
- C.31 This allowance might be calculated by reference to the cost of the building, but excluding the cost of the land on which the building stood. The relief might be set at a rate of, say, 6% reducing balance or the equivalent straight-line rate of 4%.
- C.32 As part of this reform it might be appropriate to consider what constitutes a building for these purposes and take fixtures, where these form part of the building, into the new regime. This approach would reflect the increased integration of plant in modern buildings. As a consequence, plant and machinery which forms part of a building might no longer benefit from the current 25% writing-down allowance (subject to transitional arrangements) but allowances would be available at the lower rate.
- C.33 The new writing-down allowance would be available to companies on all buildings used and occupied for the purposes of a business. It would replace and extend the existing IBA and ABA regimes and would represent a considerable simplification compared with those rules. The allowance would be given on the basis of the expenditure incurred, so there would be no need to calculate a company's entitlement by reference to the original cost of construction nor to take into consideration the allowances claimed by previous owners.
- C.34 Balancing adjustments would be made on disposal of the property, as under the current IBA regime. But the current 25-year "cut-off" point, after which no balancing charges or allowances can arise, would go.

### *Roll-over relief*

- C.35 At present profits on the sale of some properties benefit from a roll-over relief. The roll-over relief encourages reinvestment, and recognises that taking cash out of a business in the form of tax at the time of sale and reinvestment reduces the amount available for reinvestment and therefore might hinder growth and expansion. It also ensures that tax does not deter businesses from moving to more suitable premises, for example, if that is the appropriate commercial decision (in economic terms, it mitigates the “lock-in” effect of tax).
- C.36 The Government recognises the case for some form of roll-over relief within a reformed regime. A form of relief along these lines already exists in the intangibles regime. The relief works broadly as follows:
- to the extent that proceeds are reinvested, relief is available for any excess over the original cost of the asset (but there is an immediate charge to claw back any depreciation allowances which have been given);
  - the “tax cost” of the replacement asset is reduced by the amount of gain rolled over, and this reduced tax cost applies both for the purposes of calculating the profit on any future disposal and for the purposes of calculating any depreciation relief on the replacement asset.
- C.37 Both this form of roll-over and the existing relief within the chargeable gains regime provide for deferral of tax on the capital profit as long as the proceeds are reinvested. The distinctive features of the relief for intangibles relate to its interaction with the depreciation (or writing-down) allowance. The amount not rolled over equates to the allowances already given, while the restriction in the tax cost of the new asset means that allowances going forward are restricted.
- C.38 Assuming that this form of roll-over relief were to replace the existing form of roll-over relief available under the chargeable gains regime, companies disposing of assets which do not qualify for capital allowances under the current regime would generally still benefit compared with the current regime. They would simply have a reduced entitlement to allowances which they currently do not receive at all. For buildings which currently qualify for IBA, the new relief would introduce a link between roll-over relief and allowances which is not present within the current regime. IBA is currently limited to the original cost of the building and applies only where the building is acquired within 25 years of construction, whereas under the new regime any allowances would be based on the expenditure incurred on acquisition (reduced by roll-over relief where applicable) and there would be no 25-year time limit.
- C.39 Some respondents have argued that the restriction of roll-over relief to property held and used by a trader represents an outmoded distinction

between the tax treatment of trading activity and investment activity. While the Government recognises that there may be an economic case for extending the new form of roll-over relief to let commercial buildings, the case for the relief is perhaps less compelling where property is held to produce a return which is partly in the form of capital appreciation (possibly in addition to any rental income). This issue will be kept under review as the proposals develop and a decision will be made in the context of the overall package.

## **Plant and machinery**

C.40 Paragraphs C.26 and C.27 above highlighted the fact that the current tax treatment of expenditure on buildings, with relief available only for buildings qualifying for IBA or ABA, may distort commercial decisions. A similar distortion may arise where relief is generally available under the capital allowances rules for expenditure on plant and machinery but the rate of writing-down allowance may bear little relation to the true rate of economic depreciation for any particular asset.

C.41 In general, under the current capital allowances system, plant and machinery qualifies for a writing-down allowance, on a reducing balance basis, at the rate of 25% or (for assets with a life of 25 years or more) 6%. When the rates of these allowances were set, they were intended broadly to reflect the average rate of commercial depreciation over the lives of assets, but clearly there is much variation around the average. For a wide range of assets (broadly where assets have a life of between 8 and 25 years), the rate of relief exceeds the average rate of commercial depreciation. But for assets with a shorter commercial life, the relief available under the current tax system may fail to keep pace with the rate of commercial depreciation.

C.42 In principle there are two ways in which a closer approximation to economic depreciation could be achieved:

- by a move away from the current capital allowances system to relief for commercial depreciation; or
- by modifying the capital allowances system, for example by increasing the number of rates within the capital allowances system to reflect more closely the economic lives of assets.

C.43 The option of moving to commercial depreciation was raised in the August 2002 consultation document. Many respondents were keen to retain the current system of capital allowances for plant and machinery rather than replace existing capital allowances with relief for commercial depreciation. There was particular concern among sectors with high levels of investment in heavy plant, such as manufacturing, transport and utilities, that any move to commercial depreciation might reduce cash-flow advantages of existing capital allowances. The flexibility of the capital allowances regime (for example, the facility not

to claim allowances in a given year) and the certainty of obtaining relief at a given rate were also cited as advantages. Other respondents, however, saw benefits in a move to relief based on the rate of depreciation in the commercial accounts, which might be expected to bear a closer relationship to the actual rate of economic depreciation.

- C.44 Allowing relief for commercial depreciation would automatically provide for greater flexibility in the rate of relief. However, by allowing companies to take a view on the rate at which assets should be written down, it might create a lack of consistency between taxpayers in relation to expenditure on identical classes of asset.
- C.45 An alternative way of approximating economic depreciation more closely would be to increase the number of different rates of writing-down allowance so that they better reflected the economic lives of assets. On the one hand, depending on the number of different rates chosen, this could introduce additional complexity and cost. On the other, this additional complexity might be outweighed by the advantage of relief at the appropriate economic rate and would result in a more neutral treatment of assets of different types and lives than the present capital allowances system.
- C.46 Based on the responses to the August 2002 consultation document, the Government recognises that relief for capital expenditure on plant and machinery is an area of particular concern to certain sectors of industry. It also recognises that the current capital allowances system has the potential to distort business decisions. The Government would not wish to rule out options to address this distortion as possible components of a wider, balanced package of reforms aimed at improving economic efficiency and fairness.
- C.47 As part of this round of consultation, therefore, the Government would like to open up a wider debate on the role of capital allowances within the corporation tax system and their effect on investment decisions.

### ***First-year allowance schemes***

- C.48 The Government continues to see the tax system as a vehicle for promoting productivity by addressing market failures. The August 2002 consultation document confirmed the Government's commitment to retaining a mechanism for providing accelerated relief within specifically targeted schemes. (Examples of such schemes within the current system are the 40% first-year allowances for small and medium-sized enterprises and the 100% first-year allowances for investment in energy-saving equipment.) But the document also suggested that the same or similar benefits could be delivered by alternative means.
- C.49 If the current capital allowances system were to be replaced by relief for commercial depreciation, there are different ways in which the equivalent of the current first-year allowances could be delivered.

- C.50 Certain businesses might benefit from accelerated depreciation. This could be applied in the form of a deduction given in the first year, equivalent to the current first-year allowance. There would be a corresponding reduction in the depreciation charge in later years so that the total tax depreciation given over the life of the asset was equal to the total commercial depreciation charged in the accounts.
- C.51 This would provide similar benefits to the current system and could be adapted to provide a number of possible variations, for example:
- allowing a higher rate of relief for a specified number of years then reducing to a lower rate for the remainder of the asset life; or
  - providing for a fluctuating deduction over the period of the asset life.
- C.52 Appropriate records and adjustments to the accounts figures would still be needed. This might detract from the apparent simplicity of using commercial depreciation as the starting point. But this would need to be weighed against current record-keeping requirements for classes of assets that attract first-year allowances.
- C.53 An alternative would be to retain the current system of capital allowances to accelerate the timing of relief, even if capital allowances generally were to be replaced by commercial depreciation. This would provide the same benefits in a familiar form, the mechanics of which are already well understood and would be unaffected by any transitional provisions. It is, however, possible that such a hybrid system might in some cases add complexity.

## Shares

- C.54 The role in a company's business of assets which take the form of equity stakes (normally in the form of shares) in other companies will vary depending on the relative size of the investment and the nature of the business. In broad terms the shares may represent:
- a structural holding whereby a company exercises control (in the case of a holding in a subsidiary) or otherwise significantly influences the way the "target" company carries on its business;
  - part of the dealing stock of a company which carries on a financial trade or part of the holding of (mostly quoted) portfolio investments of such a company; or
  - all or part the portfolio investment of a company which is not a financial trader.
- C.55 Gains and losses on the disposal of shares in the first category are normally excluded from corporation tax under the substantial shareholdings rules introduced last year if the "target" company is a trading company. Those in the second category are usually taken into

a computation of trading profits. The computation is closely based on the (“mark to market”) accounting treatment of these assets so that profits and losses are recognised as they accrue rather than simply on realisation. The Government has no plans to change the treatment of shares in either category (though see Background Note B, paragraphs B.35 and B.36 for discussion of the possible extension of the substantial shareholding exemption).

C.56 Shares in the third category are currently within the chargeable gains rules (although gains on disposals of such shares by many collective investment vehicles are exempt). Gains and losses on these assets are recognised for corporation tax purposes under those rules on disposal, regardless of the treatment in the accounts of the company.

C.57 Chargeable gains treatment of assets in this category diverges from:

- the treatment of other financial assets (such as gilts and bonds) within the same investment portfolio where the return is recognised as income, normally in accordance with the accounting treatment under the loan relationship rules; and
- the treatment of the same assets in the investment portfolio of a financial trader (taxed as a trading matter, also in accordance with the accounting treatment - see paragraph C.55 above).

C.58 In accordance with the Government’s strategy, therefore, there is a good case for eliminating these differences by making companies’ shareholdings currently within the chargeable gains rules subject to an income regime based on the accounting treatment.

C.59 The principal issues that would arise on moving shares into a regime of this kind are:

- to what extent changes in the value of shares that are recognised in the accounts prior to disposal should also be recognised for tax purposes; and
- to what extent special computational rules would still be needed, for example for transfers of shares not at arm’s length or on certain types of business reorganisation.

### ***Changes in value prior to disposal***

C.60 It is likely that portfolio shareholdings will be shown under both UK generally accepted accounting practice (GAAP) as amended and IAS at current or fair values in companies’ accounts. Companies will take resulting differences in fair value in some instances to the profit and loss account and in others to revaluation reserves (though this is subject to current work by the standard-setters on the development of a comprehensive income statement: see paragraph C.21 above).

- C.61 In any event, the Government believes that there is a good case in principle for taxing such revaluation profits and allowing losses as they form part of the economic profit of the company for the period. This approach is consistent for example with the loan relationships and derivative contracts rules. The practical difficulties that argue against taxing revaluations of real property do not arise for portfolio shareholdings accounted for in this way, where there is generally a deep and liquid market.
- C.62 The case for recognising such changes in value is more problematic for shares which have no ready market or cannot be sold without affecting the company's business (such as shares in unquoted companies or structural holdings which are outside the substantial shareholdings exemption). But whatever practical problems this may cause will be mitigated to the extent that accounting practice continues to permit holdings of this type to be carried in a company's accounts at no more than historical cost, as is currently the case under UK GAAP and IAS 27 and 28 (subsidiary holdings and associated companies respectively).

#### ***Need for special computational rules***

- C.63 The Government recognises that special rules may be needed to defer recognition of gain or loss in relation to certain types of transactions in shares such as share exchanges. Comments are welcomed on the case for retaining similar rules for corporate shareholders within the new regime.

#### ***Interaction with substantial shareholdings exemption***

- C.64 There is an interaction between the treatment of shares generally and the substantial shareholdings exemption.
- C.65 One specific issue is the treatment of abortive expenditure on an asset potentially within the substantial shareholdings exemption. There is a case for continuing to disallow such expenditure on the basis that it would not have been allowed had the asset been acquired and subsequently disposed of.
- C.66 The Government would also welcome comments on any other significant issues relating to the interaction with the substantial shareholdings exemption.

#### **Pooling of capital profits**

- C.67 A reformed regime will need rules to determine how profits and losses arising on assets currently within the chargeable gains regime can be offset against other profits and losses. The form of any new rules will also depend to some extent on how profits are pooled under schedular reform.

- C.68 In principle, the Government favours pooling of income and capital profits and losses. This would reflect the real economic interdependence between “income” and “capital” transactions in modern business. On the other hand, the Government is aware of the risks inherent in a regime that allows any capital loss, past or present, to be set freely against any income profit. In view of these risks, alternative options for pooling are set out below, which should be considered in conjunction with the proposals on legacy losses in paragraphs C.82 to C.84 below. The Government will also be considering whether specific anti-abuse provisions might be necessary to control the manipulation of “capital” losses within a reformed regime.
- C.69 One option would be to pool capital profits and losses with the appropriate “income” pool as discussed in Background Note A:
- with full pooling this would mean putting all chargeable gains and allowable capital losses into the income pool;
  - with trading-letting pooling this would mean putting gains or losses on property (and on plant and machinery used for the purposes of a trade or a letting business – in practice, almost all plant and machinery) into the trading-letting pool. Gains and losses on shares not already treated as part of trading activity would be pooled with non-trading loan relationships. Special rules would be needed for life assurance companies subject to the “I minus E” basis of taxation.
- C.70 A second option would be to segregate capital profits and losses in a “capital” pool.
- C.71 A third option would be to include capital profits with the appropriate income pool as discussed in Background Note A, but to exclude capital losses. Capital profits of the year would first be set against capital losses (both those of the year and those brought forward); any net capital profits would be included in the appropriate income pool. This would allow income losses to be set against capital profits but capital losses would not be available to set against income profits. Such an approach would give greater flexibility to companies than complete segregation while limiting the risks to the Exchequer of allowing capital losses to be used against income.
- C.72 In combination with the creation of a trading-letting pool as discussed in Background Note A, this option would have the benefit of allowing interest related to let property to be carried forward and set against any capital profits on eventual disposal of the property (see paragraph A.26).
- C.73 The Government’s decision on these options will take into account the relative costs to the Exchequer of increased flexibility. The decision will also inform how the transition will be dealt with (see paragraphs C.74 to C.85 below).

## **Transition**

C.74 Many respondents expressed concern about the transition to a new regime. A series of different options for transition – fast, slow and intermediate – are set out below. It might be appropriate to adopt different transitional arrangements for different categories of asset.

### ***Fast transition***

C.75 There is a precedent in the loan relationships legislation in Finance Act 1996 and the derivative contracts rules in Finance Act 2002 for removing assets from a former chargeable gains regime and bringing them into an income regime. Broadly, where an asset was formerly subject to chargeable gains rules, the loan relationships rules deemed a disposal and held over the resulting gain or loss until actual disposal of the asset.

C.76 A similar approach to transition here would work as follows. Where an asset produced a gain on the deemed disposal the gain could be held over until eventual disposal. Any new allowances available under the reformed regime would be restricted until this gain was recouped. Any residual gain would be charged on a later disposal. Where an asset produced a loss on a deemed disposal, the allowances available under the new regime would be given immediately. Any asset attracting a writing down allowance under current law, would continue to benefit from the allowance until eventual disposal.

C.77 This method would bring assets into the new regime quickly, reducing the compliance costs of operating two schemes at once. It would, however, involve agreeing valuations for deemed disposal purposes, though in many cases an estimation of the value would suffice to determine whether an allowance was due.

### ***Slow transition***

C.78 This method would leave existing assets subject to the old regime and bring new assets into the new regime if acquired from an unconnected party after the commencement date. It would have the disadvantage of requiring companies and the Revenue to operate two regimes for a potentially very long period.

### ***Intermediate transition***

C.79 Rather than bringing all assets into the new regime at once it might be more appropriate to stagger the transition, leaving assets in the old regime until the earlier of the first disposal of the asset to an unconnected party or the expiration of a set period such as 6 or 10 years (at which time there might be a deemed disposal). The period might be different for different classes of asset.

- C.80 Assets would be within the regime when acquired from an unconnected party after the commencement date.
- C.81 This method would stagger the move into the new regime while not leaving companies with the problem of operating two regimes for an indeterminate period.

### ***Legacy losses***

- C.82 Many companies will carry forward realised losses at commencement of the new regime (“legacy losses”). The options depend on the form of pooling adopted in the new regime.
- C.83 Under pooling options 2 and 3 (see paragraphs C.70 to C.72 above), where capital losses are not set against income profits, it would seem appropriate to let legacy capital losses be carried forward and set against subsequent capital profits.
- C.84 Under option 1, where capital losses are pooled with income profits and losses, it would not be appropriate for capital losses realised under the old regime to be carried forward and set against income in these pools. Pre-existing capital losses would be available only to set against profits realised on those assets held at commencement (including both any gain on a “deemed disposal” under a fast or intermediate transition, and any profit accruing subsequently) but would be set off before pooling to maximise use.

### ***Assets on which capital allowances are currently available***

- C.85 For assets held at commencement on which capital allowances are currently available (plant and machinery as defined under current rules and buildings qualifying for allowances), the current allowances regime would continue to run until disposal. If changes were to be made to capital allowances, there would therefore be a significant transitional period in respect of those allowances, even if a fast transition were to be adopted for capital gains purposes. Arrangements might, however, be made to release pools of expenditure on plant and machinery once these had been depleted to a minimal level.

### **Controlled foreign companies**

- C.86 The August 2002 consultation document noted that the natural consequence of moving gains into an income regime would be that profits on asset disposals would come within the scope of the Controlled Foreign Companies (CFC) rules. CFCs might also benefit from any extension of relief for capital expenditure.
- C.87 Responses to the consultation were mixed:

- some respondents noted that gains had been excluded from the CFC regime for good reason and did not agree that the natural consequence was to bring gains into the CFC regime;
- others agreed that gains should be included within the CFC charge although some of them felt that only gains that arose outside the UK for reasons connected with avoiding tax should be targeted;
- there was considerable concern about the potential complexity of bringing gains within the CFC rules. Many commentators thought the exemptions in the current regime would need substantial adaptation;
- there was also concern that the inclusion of gains would act as a disincentive to company reorganisations, unless the availability of the substantial shareholding exemption were to be extended;
- some suggested that as far as possible all reliefs remaining available under the wider reform to the chargeable gains regime should be extended to CFCs; and
- many respondents wanted to keep their options open pending sight of more detailed proposals for bringing gains into income.

### ***The Government's response***

C.88 In taking forward this strand of the reform, the Government's view remains that bringing gains of CFCs into charge within the regime is the natural consequence of removing the distortions between the taxation of capital profits and income. However it recognises that there are substantial issues here that would need to be addressed if this aspect of the reform were to be taken forward.

## **Specific sectoral regimes**

### ***Life companies***

C.89 In the August 2002 consultation document the Government recognised that the kind of reforms suggested for portfolio shares outlined in paragraphs C.54 onwards could have its most substantial tax effect on life assurance companies. This raises a number of complex issues especially as, in many companies, most of the gains on shares accrue for the benefit of individual policy holders. Were they to own the assets directly instead of through the pooling mechanism of life assurance investment, they would have a very different tax treatment. Changes in the tax treatment of commercial property would likewise have a substantial effect on life assurance companies.

C.90 It is the object of the special rates of corporation tax on the policy holders' share of life assurance company profits to reflect, as far as is

practicable, the tax treatment of direct investment - as shown by the reduction in the corporation tax rate on policy holders' gains in Finance Act 2003. The Government therefore recognises that very careful consideration would have to be given both to how to reflect the changes in the life company tax regime and whether to do so. But, tax rates apart, the way in which liability to capital gains tax is computed for an individual and the way in which corporation tax on chargeable gains is calculated for life assurance companies has diverged markedly in the last few years, and the corporation tax rules have never recognised any equivalent to the annual exempt amount.

C.91 Bearing this in mind, possible options for life assurance companies might be to:

- exclude *all* of the remaining capital assets from the new rules;
- exclude the policy holders' share of the remaining capital assets from the new rules, leaving those assets within either the existing corporation tax rules for chargeable gains or a modified form of capital gains tax, perhaps offering taper relief instead of indexation; or
- include all the remaining capital assets within the new rules but adjust the rate of corporation tax on the policy holders' share of gains in a way that reflected the effect of the new rules.

### ***Collective investment schemes***

C.92 The Government will continue to review the potential impact of corporation tax reform upon other vehicles for pooled investment such as authorised unit trusts, open-ended investment companies, approved investment trusts and venture capital trusts. Presently these vehicles are exempt from corporation tax on chargeable gains, and the Government will continue to work with providers and other interested parties to ensure that the special position of these vehicles is addressed.

### **Points on which the government requests comments**

C.93 The Government would welcome views generally on the ideas discussed in this background note and specifically on the following points:

#### ***General approach***

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

### ***Land and buildings***

- What would be the relative advantages and disadvantages of relief for the cost of buildings based on commercial depreciation (as outlined in paragraphs C.28 and C.29) or based on a fixed rate of annual allowance (as outlined in paragraphs C.30 and C.31)?
- Would moving the boundaries between items qualifying for plant and machinery allowances and those items qualifying for the new building allowance produce a more coherent and sensible division of costs? Are there any potential problem areas?
- Comments are invited on the proposals for a new form of roll-over relief.

### ***Plant and machinery***

- Would economic efficiency be improved by a system of relief for capital expenditure which aimed to reflect economic depreciation more closely?
- If it is considered desirable for relief to approximate more closely to economic depreciation, how might this best be achieved? By allowing relief for commercial depreciation as shown in the accounts; or by modifying the capital allowances system, for example increasing the number of different rates?
- To what extent do capital allowances influence the level and timing of investment in practice?
- To the extent that capital allowances do have an influence, what features of the capital allowances system are most important? Is it, for example, the rate of allowance, or other factors such as the flexibility or certainty of the regime?
- What features of the current capital allowances system are attractive to business for other reasons?
- What are respondents' views on the options to deliver specifically targeted, enhanced allowances within a depreciation regime?

### ***Shares***

- Comments are sought on any specific rules that respondents would wish to see retained.
- Comments are also welcome on any other issues arising from the proposals, including their interaction with the substantial shareholdings exemption.

### ***Pooling of capital profits***

- What are respondents' views on the three options to deal with profits or losses on disposal?
- How would each of these options affect the benefits of schedular reform (either trading-letting pooling or full pooling, as set out in Background Note A)?

### ***Transition***

- Comments are invited on the options for transition.
- What are the most important factors that any design for transition should address?
- Would different asset types benefit from different transitions?

### ***Controlled foreign companies***

- Should the CFC regime be modelled as closely as possible on the wider regime, or should it seek to replicate only those elements which are readily transferable?
- The Government would also welcome views on any implications specific to CFCs arising from other reform options highlighted elsewhere in this document (for example, the adoption of IAS).

### ***Life companies***

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

### ***Administrative costs and savings***

- What would be the effect on compliance costs of the various options for the taxation of capital profits and relief for capital expenditure set out in this background note?
- How would any administrative savings/costs affect small, medium and large companies?
- How would any administrative savings/costs affect companies in different business sectors?

## BACKGROUND NOTE D

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### SUMMARY OF CONSULTATION RESPONSES

- D.1 The August 2002 consultation document attracted over 150 written responses, many of which were very wide-ranging. In addition, a number of consultative meetings were held with interested parties. This background note is a summary of the main points made.
- D.2 A full list of respondents (other than those who requested confidentiality) may be obtained on request by e-mail to [george.gillham@ir.gsi.gov.uk](mailto:george.gillham@ir.gsi.gov.uk); or by post to George Gillham, Inland Revenue Business Tax, Room 5E1, 22 Kingsway, London WC2B 6NR. Telephone requests may be made on 020 7438 9019.

#### ***General points***

- D.3 Abolition of the schedular system was most commonly identified as the top priority, with trading/investment reforms in second place.
- D.4 Some respondents favoured taxing accounting profits. They suggested that this would be much simpler than the complicated tax adjustments that are currently needed, making the calculation of tax more straightforward and eliminating the need to keep detailed histories of assets to compute chargeable gains.
- D.5 There was concern that International Accounting Standards are in a state of flux. Related to this there was also concern at the likelihood of moving towards fair value accounting.
- D.6 There was strong support for the elimination of tax nothings, including abortive capital expenditure and payments to terminate onerous leases.
- D.7 There were mixed views regarding taxation on a consolidated basis, but respondents generally felt that it should either be a later step or should not be pursued at all. There was some interest in filing a consolidated return aggregating the taxable results of group companies.

#### ***The schedular system***

- D.8 The present schedular system was generally regarded as outmoded. The inability to set trading losses carried forward against other income was widely identified as something which could discourage diversification and could tip the balance against some investment decisions. The boundary between trading and letting income was also identified as a compliance burden.

- D.9 The most popular option by far was total abolition of the schedular system. The cited benefits of complete abolition included making commercial decision-making easier, encouraging inward investment, encouraging companies to change from loss-making to profitable activities and reducing compliance costs.
- D.10 Merging trading and letting income was the next most popular option after total abolition of the schedular system. This was felt to offer simplification for smaller companies. There was interest in putting credits and debits on loan relationships attributable to property into the pool of trading and letting income.
- D.11 Liberal loss relief rules were preferred. However, respondents accepted that new measures to guard against artificial losses and loss-buying might be needed, and recognised that there might be cost constraints on how far the Government could go. Some respondents suggested that the group relief rules should also be re-considered.
- D.12 The free use of pre-commencement losses on the same terms as post-commencement losses was widely favoured. However, it was recognised that Exchequer cost would be a concern. There was a general inclination to favour streaming pre-commencement losses, keeping them subject to existing schedular restrictions. This was more popular than a shadow regime, which was thought to be too complex.
- D.13 Several advocates of total abolition of the schedular system pointed out that foreign income should be treated in a way that would allow double taxation relief to be computed.

#### ***Tax differences between trading companies and investment companies***

- D.14 There was a general view that the tax distinction between trading and investment companies was not valid in today's business environment. It was suggested that because the boundary was drawn in different places in the corporation tax system it increased compliance costs, complexity and uncertainty. Commentators said that investment and trading companies are operated on similar business principles and consequently the tax treatments of both types of company should be the same.
- D.15 It was also suggested that the current tax implications of the distinction are contradictory. Trading is perceived to be generally more favoured but there are circumstances in which investment companies enjoy privileges. Groups with a mixture of trading and investment activities artificially segregated these into separate companies to achieve certainty of tax treatment. This increases administration and compliance costs.
- D.16 Concerns were expressed that some companies do not fall neatly into the current trading or investment categories. For example, a "hybrid" company, (which carries on a trade but also engages in investment

activity, perhaps as the holding company of a group) may not qualify as an investment company and may therefore be unable to get relief for the expenses of managing its investments.

- D.17 There was a general view that the number of boundaries should be minimal (ideally none). If distinctions do remain, these should be clear, with a coherent policy rationale across the corporation tax system as far as possible.
- D.18 There was little support for a new active/passive company distinction. This was seen as a move from one complex system to another.
- D.19 It was suggested that the rules for allowable tax deductions of trading and investment companies should be replaced with a general relief for all genuine business expenditure (excepting items where relief was denied for policy reasons, e.g. entertainment).
- D.20 Changes were also advocated in other areas where the difference between trading and investment has tax implications, including: extending the substantial shareholdings exemption to non-trading companies, at the level of both the shareholding company and the investee company; and removing the restriction on roll-over relief on replacement of business assets to assets used for the purposes of a trade.
- D.21 “Corporate wrappers” for personal investments were generally not perceived as a serious threat to the Exchequer given the existence of taper relief and the tax implications of companies paying dividends, though respondents acknowledged that some protection of the personal tax base might be necessary.

### ***The taxation of capital assets***

- D.22 There was some support for the concept of abolishing the capital/revenue divide. Mixed views were received on whether taking gains into an income regime would simplify the corporation tax system. It was suggested that the nature of transitional arrangements needed careful thought and some of the permanent features of any new regime could make it at least as complicated as the current system and probably more so.
- D.23 Responses on the nature of the transition were mixed. There was widespread recognition that a long transition could be very complex and that a short transition could be “unfair”. There was a view that complexity might be unacceptable and might have difficult sectoral implications. There were various suggestions to accommodate the transition. These included:
- allowing companies to elect whether to bring old assets into the new regime;

- the rebasing of existing assets; and
  - the idea that a commencement day gain might be computed at market value and held over until disposal.
- D.24 It was felt that capital losses brought forward at commencement should be available (at least) for offset against asset gains under both old and new rules. The proposal in the August 2002 consultative document that the use of such losses should be restricted to gains on pre-commencement assets (taxed under old rules) was not popular, though there was recognition that Exchequer cost might be a limiting factor.
- D.25 There was little support for the possible taxation of unrealised gains, particularly on investment property. Respondents expressed concern that to tax companies where no cash has been generated would create difficulties.
- D.26 There was widespread support for the inclusion of roll-over relief in any new regime so that profits would not be subject to tax when they were reinvested. The general view was that any increased complexity that roll-over might bring would be worthwhile. There were mixed views on extending roll-over to non-trade assets.
- D.27 There was support for retaining indexation relief, particularly among those holding assets for the long term. Some respondents accepted, however, that it might be possible to dispense with indexation accruing after the commencement of a new regime as part of a balanced package of reforms. It was generally felt that accrued indexation up to commencement of any new regime should be preserved.
- D.28 There was some concern at the suggestion that income treatment for gains would mean their inclusion within the controlled foreign companies regime.
- D.29 There were mixed views on the idea of replacing capital allowances with relief for commercial depreciation. While some saw benefits in a move to relief based on depreciation in the commercial accounts, others were concerned about losing the perceived benefits of the current capital allowances system. The main issues were:
- the deferral of relief for items such as heavy plant, where the current capital allowances provide a cash-flow benefit compared with the rate of commercial depreciation;
  - the fact that investment property was not depreciated so that property companies would lose the relief currently available on items that can be claimed as plant; and
  - the existing ability to defer capital allowances claims, which was seen as important by cyclical businesses.

- D.30 There were suggestions for retaining the current system and extending capital allowances to all capital expenditure, or providing some kind of fixed-rate relief for non-depreciating assets within any system based on depreciation.
- D.31 A hybrid system (capital allowances for assets that currently qualify and commercial depreciation for those that do not) was generally viewed as too complicated.
- D.32 There was widespread support for first-year allowance schemes (for example, 40% first-year allowances for small and medium-sized enterprises) to be retained in some form.

# BACKGROUND NOTE E

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## PARTIAL REGULATORY IMPACT ASSESSMENT

### Introduction

#### *Background*

- E.1 This partial regulatory impact assessment (RIA) has been produced to accompany the August 2003 document on the reform of corporation tax. Any changes arising from that document are likely to affect most companies. The August 2003 document builds on responses to the August 2002 consultation document and puts the discussion into the wider European and international context.
- E.2 This partial RIA outlines the options discussed in the August 2003 document and should be read in conjunction with that document and with Background Notes A to C. The Government would welcome input from respondents to help to quantify the impacts of those options. The Government will produce further RIAs at appropriate stages in the consultation.

#### *Objectives*

- E.3 The same objectives that have guided earlier corporation tax reforms will continue to guide future reforms. Within the basic framework of raising tax revenue, these are:
- business competitiveness: reducing tax distortions and promoting productivity by tackling market failures that ultimately undermine growth;
  - fairness: ensuring that individual businesses pay their fair share of tax in relation to their commercial profits; and
  - maintaining a transparent, coherent, low rate, broad-based system that facilitates decision making that is driven by commercial factors, and removing outdated and ineffective restrictions.
- E.4 The Government considers that the possible reforms discussed below meet these criteria.

#### *Reasons for acting*

- E.5 The primary reason for acting is the importance of maintaining the competitiveness of the corporation tax system, keeping in step with the changing business environment. If reforms are not made, the tax system may become increasingly detached from the realities of the

modern commercial world, resulting in a reduction in the UK's international standing as a competitive place in which and from which to do business.

- E.6 A secondary reason for acting is that, in relation to transfer pricing and thin capitalisation, there is uncertainty about the interaction between European Union law, the corporation tax systems of member states and the principles of international taxation agreed through the Organisation for Economic Co-operation and Development (the OECD). Groups of companies need certainty in order to be able to plan and to take investment decisions, and equally the Government needs certainty.

## **Options**

- E.7 The August 2002 consultation document explored three areas for potential further reform of corporation tax: reform of the schedular system; the differences in the tax treatment of trading and investment companies; and the tax treatment of capital assets not covered by earlier reforms. The current document takes forward these areas, and also introduces some new areas for possible reform.
- E.8 The Government invites comments on the likely regulatory impacts (both benefits and costs) from each of the options in all of the areas covered below.

### ***Reform of the schedular system***

- E.9 Two options have emerged as the front-runners in this area: pooling all income from trading and letting activities, and full abolition of the schedular system (pooling income from all sources). Leaving the schedular system unchanged would of course also be a possibility.

### ***The distinction between trading and investment companies***

- E.10 Respondents to the August 2002 consultation document commented that the distinction between the expenses regimes for trading and investment companies increases compliance work, administration costs and uncertainty for companies. Any or all of the following changes would be possible: to remove the requirement for a company to qualify as an investment company in order to obtain relief for the expenses of managing its investments; to align the rules for management expenses (for example, on the timing of the deduction) more closely with their accounting treatment; to extend the substantial shareholdings exemption to disposals by investment companies; and to extend the scope of roll-over relief.

### ***The tax treatment of capital assets not covered by earlier reforms***

- E.11 With regard to capital profits and losses, it would be possible to have a closer alignment with the accounting treatment, subject to exceptions

where accounting standards would lead to a treatment that was inappropriate for tax purposes. As part of such an alignment, future indexation relief would be abolished.

- E.12 It would also be possible to introduce a new allowance for capital expenditure on commercial and industrial buildings, which could be based either on commercial depreciation or on a fixed rate of annual allowance. In addition, the boundary between plant and buildings could be re-assessed. It would also be possible to introduce a wider range of rates of capital allowance for expenditure on plant and machinery, or to move to allowing commercial depreciation of plant and machinery.
- E.13 Current tax rules do not always lead to an appropriate interaction between investment and the incidence of taxation. It would be possible to change the taxation of leased plant and machinery where leases are essentially financing transactions. For such leases it would be possible to transfer entitlement to capital allowances from lessors to lessees.

### ***Transfer pricing***

- E.14 The Government proposes to apply transfer pricing rules to transactions within the UK and to repeal existing legislation on thin capitalisation. Transfer pricing is not a direct issue for many companies that are not part of a group structure. But the rules can also apply to transactions between a company and individuals.
- E.15 For small businesses, it would however generally be inappropriate to apply transfer pricing rules. The Government therefore invites comments on the possibility of accompanying the application of transfer pricing rules to UK transactions with appropriate measures to mitigate the administrative impact.

## **Costs and benefits**

### ***Implementation benefits to companies***

- E.16 The implementation benefits that the Government has identified in these proposals relate mostly to the removal or alteration of some rules in the tax system that may distort business investment and may limit the efficiency of business operations, and to the giving of greater flexibility to companies in how they operate.
- E.17 It was clear from the responses to the August 2002 consultation document that reform of the schedular system has the potential to improve business efficiency due to the more flexible availability of losses. It also has the potential to save compliance costs because there would be less need to categorise profits specifically for tax purposes.

- E.18 Responses to the August 2002 consultation document also confirmed that reform of the distinction between trading and investment companies has the potential to make it easier for groups to obtain relief for management expenses, and to allow greater flexibility in group structures. If a group simplified its structure, that would have the potential to lead to long-term savings in the costs of administering the group.
- E.19 It is not yet possible to quantify the savings identified in E17 and E18 and the Government would welcome further input from business in order to do this. Background Notes A and B include questions which will help companies to formulate their input.
- E.20 Changes to the tax treatment of capital assets have the potential to reduce compliance costs, because of a greater alignment between the accounting and tax treatments of transactions. It might also be possible to give allowances for a wider range of capital expenditure than at the moment.
- E.21 Changes to the leasing legislation could reduce distortions between different sources of finance. Such changes could also allow repeal of the rules that restrict capital allowances on overseas leasing, and of some anti-avoidance legislation.
- E.22 Changes to transfer pricing and thin capitalisation legislation would include mitigations for smaller businesses which would apply equally to UK and international transactions. This could reduce the current burden for some companies that currently have small cross-border transfer pricing issues.
- E.23 The Government welcomes comments on all of the ways in which implementation benefits might arise, and on the likely extent of those benefits. The Government would particularly welcome offers to provide detailed case studies of the extent of the effects on particular companies or groups of companies, or on particular business sectors.

#### ***Implementation costs for companies***

- E.24 All of the possible reforms could impose some transitional compliance costs as companies adapted to new rules. The nature of transitional arrangements would be likely to influence any such costs, but they may be expected to include familiarising staff with the new rules.
- E.25 Changes to the leasing legislation could impose some ongoing compliance costs, particularly in relation to the small proportion of leases which are essentially financing transactions but are accounted for as operating leases.
- E.26 Changes to transfer pricing and thin capitalisation legislation could impose ongoing compliance costs in the determination of arm's-length terms for transactions between related parties.

E.27 The Government would welcome comments on all of the ways in which these costs might arise, and on the likely extent of any such costs. As mentioned in paragraph E.23 above, the Government would particularly welcome offers to provide detailed case studies of the impact of the possible changes on particular companies or groups of companies, or on particular business sectors.

## **Equity and fairness**

E.28 The possible reforms are likely to affect the compliance burdens on different companies to different extents.

E.29 Schedular reform could be of particular benefit to companies with a wide range of different sources of income. Reform of the distinction between trading and investment companies has the potential to be of particular benefit to companies and groups with a mixture of trading and investment activities, and to groups with complex structures that they would like to simplify.

E.30 Changes to the treatment of capital assets could have most effect on companies with extensive holdings of such assets. Those holding investments could be particularly affected by changes to the computation of capital gains, while those making extensive use of plant and buildings in their trades could be particularly affected by possible reforms of the capital allowances regime.

E.31 Changes to the leasing rules could affect some lessors and lessees who entered into leases of plant and machinery that were essentially financing transactions. In most cases there would be little or no overall effect but there could be some adverse effect, particularly in relation to some longer leases.

E.32 The extension of the transfer pricing regime to domestic transactions would primarily have the potential to affect groups that engaged in intra-group domestic transactions. Many groups already price domestic transactions between related parties on an arm's-length basis. The compliance implications for such groups would be considerably less as a consequence. Moreover many businesses, particularly smaller businesses, could also benefit from the mitigation measures that the Government would introduce.

E.33 The Government would welcome comments on all of the ways in which the possible reforms might affect different types of company or group to different extents, and on the likely level of any differences between effects.

## **Impact on small business**

- E.34 Small business representatives have been involved throughout the formal consultation process that arose from the August 2002 consultation document.
- E.35 After considering the options discussed in the August 2002 document, representatives of small business suggested that moves to align taxable profits more closely with accounting profits would be likely to ease the compliance burden on smaller companies. Similarly, they suggested that schedular reform would be of real benefit to smaller companies – particularly those that have diversified in order to enhance their viability. The possibility of reform to the distinction between trading and investment companies was also welcomed. However, representatives of small business expressed some concerns about any reforms to the taxation of capital assets that could result in the taxation of unrealised gains.
- E.36 Changes to the taxation of leasing could affect small businesses to the extent that they lease assets over fairly long terms under leases that are essentially financing transactions. The Government would particularly welcome comments on this issue.
- E.37 Changes to the transfer pricing rules could also have an impact on small business. The Government is considering appropriate measures to mitigate the impact of the transfer pricing regime and is keen to encourage input from small businesses as to the form such mitigation might take.
- E.38 The Government will continue to make particular efforts to ensure that the view of small businesses are fully identified and taken into account throughout the next stage of the consultation. Small businesses will no doubt wish to concentrate on those proposals that most directly affect them. Small businesses wishing to discuss any aspect of the proposals should contact George Gillham as noted in E46.

## **Competition assessment**

- E.39 The Government has reviewed the possible reforms in the light of the competition assessment process, which indicates that a competition assessment is not required at this time. While some companies would be affected more than others by the possible reforms, this is not expected to have a significant effect on the structure of competition in most industries. The Government does not anticipate that new businesses will be disadvantaged by these reforms. Competition issues will be kept under review as the consultation process develops.

## **Environmental impact assessment**

- E.40 Any reforms that are made to the capital allowances system as a whole have the potential to have an impact on the regimes for environmentally sensitive assets, including land and buildings. The Government recognises that there may be a need for an environmental impact assessment in order to assess the environmental impacts of any changes to the capital allowances regimes for these assets.

## **Securing compliance**

- E.41 Some of the possible reforms might require changes to be made to the Inland Revenue's compliance processes. In most cases the changes would be to the detail: the early stage of development of these possible reforms makes it difficult to speculate as to what any changes might be. However, most changes would be to ways of reporting, and of calculating profits and liability, rather than to the way in which the Inland Revenue examines returns and accounts and monitors compliance with the corporation tax regime.
- E.42 The question of compliance will be considered as an integral part of the development of the possible reforms.

## **Invitation to comment and contact details**

- E.43 The Government invites comments specifically on the content of this RIA, as well as responses to the document as a whole.
- E.44 Although the Government has not in this RIA identified any alternatives to regulation for further consideration, it invites proposals for alternatives to regulation that fulfil the objectives set out in paragraph E.3 above.
- E.45 The Government intends that a series of consultation meetings with companies and business representative bodies will be held in the 12 weeks following the publication of the document.
- E.46 Responses to this RIA may be made by e-mail to [George.Gillham@ir.gsi.gov.uk](mailto:George.Gillham@ir.gsi.gov.uk); or by post to George Gillham, Inland Revenue Business Tax, Room 5E1, 22 Kingsway, London WC2B 6NR. Telephone enquiries may be made on 020 7438 9019.

## BACKGROUND NOTE F

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### **POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS**

The Government would welcome views generally on the ideas discussed in the main document and the background notes, and specifically on the following questions.

The list of questions here includes all questions from both the main document and the background notes.

#### **Rationalisation of the schedular system (Chapter 2 and Background Note A)**

##### ***Types of pooling***

1. What would be the extent of the benefits delivered by full pooling?
2. What would be the extent of benefits delivered by pooling all sources of trading income and income from property?
3. Would there be disadvantages in either form of pooling, or any difficulties in implementation?
4. Should the scope of trading-letting pooling be as defined in this background note, or should the boundaries of the pool be changed?
5. Would it be better to combine items outside the trading-letting pool into a single pool, or to keep them in their current separate categories?

##### ***Loss relief***

6. What loss relief rules would be appropriate for each type of schedular reform?
7. If relief for pre-commencement losses had to be limited, what would be the best way of doing so?
8. On the transfer of an activity to another company in common ownership, would it be better to identify a proportion of losses within a pool to transfer or to leave losses with the original company? If the former, how could the proportion of losses best be computed?
9. What treatment of losses would be appropriate on a change in ownership of a company?

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

10. How should pre-trading and pre-letting expenditure be treated?
11. What would be the most appropriate approach to double taxation relief computations?

### ***Specific types of business***

12. How, if at all, should conditions for shareholder investment incentives be amended to preserve their broad effect following schedular reform?
13. How should mutual business be treated?
14. In what ways, if any, should schedular reform affect the treatment of life assurance?
15. Would treating non-North Sea upstream oil and gas trades in the same way as other trades give rise to any special issues?

### ***Administrative costs and savings***

16. What would be the likely compliance cost savings to companies from trading-letting pooling and from full pooling?
17. How would these savings affect small, medium and large companies differently?
18. How would sectoral issues affect the savings?
19. Would the schedular reform proposals reduce the amount of record-keeping that companies had to do, and what savings would follow from this?
20. Would any of the possible changes to the schedular system produce any ongoing additional compliance costs for companies? How?
21. Would changes to the schedular system produce any one-off costs relating to restructuring activity? How?

## **The tax differences between trading companies and investment companies (Chapter 2 and Background Note B)**

### ***Expenses rules***

22. Comments are invited on the possible removal of the requirement to qualify as an investment company in order to obtain relief for the expenses of managing investments. To what extent would group re-structuring be facilitated by such a change?
23. Comments are invited on the possible closer alignment of the management expenses rules with the accounting treatment (for example,

by following the accounts in relation to the timing of the deduction). Would there be any disadvantages in such a change?

24. What would be the practical effects of these changes for companies?
25. How would the changes affect different sectors and sizes of company?
26. Do respondents see any issues arising from the interaction between these changes and the proposed reforms of the schedular system and the taxation of capital assets?
27. Comments are also invited on the idea of a single business expenses rule. What would be the preferred form of such a rule?
28. What modifications to the special rules for management expenses of insurance companies might be included in any general changes to the management expenses regime?

### ***Substantial shareholdings exemption***

29. What would be the benefits of the possible extension of the substantial shareholdings exemption to shareholder companies that are investment companies? Would there be any disadvantages?
30. Comments are invited on the Government's view that avoidance concerns would make the extension of the exemption to non-trading investee companies too risky.
31. Are there other aspects of the exemption which you think the Government should examine in the context of corporation tax reform?

### ***Other issues***

32. Looking towards the future, which other shareholder reliefs would business identify as a priority for review (assuming that the current distinction was no longer required for Exchequer protection)? What would be the likely effect on business of removing the distinction in these areas?
33. What new anti-avoidance provisions would respondents be prepared to see introduced in order to facilitate such changes?

### ***Administrative costs and savings***

34. What would be the likely administrative cost savings for companies from the proposed changes to the expenses rules?
35. How would these administrative cost savings affect small, medium sized and large companies differently?
36. How would sectoral issues affect the administrative cost savings?

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

## **The taxation of capital assets (Chapter 2 and Background Note C)**

### ***General approach***

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

### ***Land and buildings***

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

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

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

### ***Plant and machinery***

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

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

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

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

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

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

## **Shares**

48. Comments are sought on any specific rules that respondents would wish to see retained.
49. Comments are also welcome on any other issues arising from the proposals, including their interaction with the substantial shareholdings exemption.

## **Pooling of capital profits**

50. What are respondents' views on the three options to deal with profits or losses on disposal?
51. How would each of these options affect the benefits of schedular reform (either trading-letting pooling or full pooling, as set out in Background Note A)?

## **Transition**

52. Comments are invited on the options for transition.
53. What are the most important factors that any design for transition should address?
54. Would different asset types benefit from different transitions?

## **Controlled foreign companies**

55. Should the CFC regime be modelled as closely as possible on the wider regime, or should it seek to replicate only those elements which are readily transferable?
56. The Government would also welcome views on any implications specific to CFCs arising from other reform options highlighted elsewhere in this document (for example, the adoption of IAS).

## **Life companies**

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

## **Administrative costs and savings**

58. What would be the effect on compliance costs of the various options for the taxation of capital profits and relief for capital expenditure set out in this background note?
59. How would any administrative savings/costs affect small, medium and large companies?

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

### **Leasing (Chapter 2)**

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

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

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

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

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

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

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