

## **CORPORATION TAX:**

### **RESPONSES TO THE JULY 2001 LARGE BUSINESS TAXATION CONSULTATION**

### **AN EXEMPTION FOR SUBSTANTIAL SHAREHOLDINGS**

#### **A TECHNICAL NOTE BY THE INLAND REVENUE**

Comments are invited on the draft clauses and the partial regulatory impact assessment set out at Annexes A and C respectively of the Technical Note. These should be sent to:

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to arrive no later than 31 January 2002.

*In accordance with the Inland Revenue's Code of Practice on consultation, once the outcome of the consultation is announced, we will make available, on request, responses to consultative documents, unless any respondent has asked for his or her comments to be treated as confidential. If you wish the whole of your comments, or your name and address, to be treated as confidential, please say so when you return your comments.*

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# LARGE BUSINESS TAXATION : CORPORATE TAX REFORMS

## Chapter 1

### THE GOVERNMENT'S STRATEGY

1.1 In July, the Government set out its strategy for creating a modern corporate tax regime that will provide stability for business in the longer term.

1.2 The July document detailed the policy objectives underpinning the reforms made since 1997 and how these principles had been turned into practice in the last Parliament by:

- maintaining a low rate, broad base system;
- reducing tax distortions and market failures;
- removing outdated and ineffective restrictions;
- countering tax avoidance.

1.3 In that document the Government confirmed its commitment to creating the best possible location for investment, keeping taxes on business as low as possible and ensuring that the tax system reflects the realities of the modern business environment.

1.4 The Government sees the key principles for future corporate tax reform as:

- **business competitiveness:** to create the best possible location for investment by removing tax distortions and promoting productivity;
- **fairness:** ensuring individual businesses pay their fair share of tax in relation to their commercial profits and compete on a level playing field.

1.5 Within this framework the Government is continuing to reform and modernise the corporate tax system. There will be new regimes for:

- intangible assets ;
- corporate debt, financial instruments and foreign exchange gains and losses.

1.6 In addition, the Government has proposed a relief for capital gains on disposals of companies' substantial shareholdings. Such a relief would facilitate the process of group restructuring and reinvestment, helping business take best advantage of emerging global opportunities. The July

document set out alternative proposals for this relief and these are discussed further in chapter 2 of this document.

1.7 In considering a relief for capital gains on disposals of substantial shareholdings, wider issues had been raised about the direction for UK tax reform, in particular the treatment of foreign dividends. The Government's approach to possible reform of these issues was set out in the July document. The outcome is discussed further in chapter 3.

1.8 Fifty-four responses were received in response to the July document.

1.9 All welcomed the opportunity to participate in the consultation process. Individual respondents had particular comments to make from their own industry and sector perspectives, but respondents generally supported the key principles upon which the Government is basing its corporate tax reforms.

## **Conclusion**

1.10 The Government is grateful for the responses provided to the July document and is encouraged by the positive welcome given by business to its strategy.

## **Chapter 2**

### **TAXATION OF RETURNS FROM SUBSTANTIAL SHAREHOLDINGS : RELIEF FOR CAPITAL GAINS**

2.1 Companies that wish to restructure, particularly groups, may face large tax charges on any resulting capital gains. This can lead to essential business decisions on restructuring and reinvestment being influenced by the tax system. The Government's solution to this is a comprehensive relief for capital gains on substantial shareholdings.

2.2 The July document put forward two proposals:

- a relief based on a deferral of the tax charge where the sale proceeds are reinvested;
- an exemption for gains, and a disregard for losses, arising from the disposal of substantial shareholdings.

2.3 Whilst respondents accepted that a deferral relief would provide significant benefits to UK companies, all thought that an exemption was preferable. An exemption was seen as more transparent, producing fewer distortions than deferral. It was also seen as administratively much simpler, requiring no tracking of the asset or assets into which the sale proceeds of the substantial shareholding had been invested. Respondents felt that an exemption would provide greater certainty for business and was more in line with the regimes in other European countries.

2.4 The Government had already indicated its preference for an exemption, subject to the views of business. In the light of the responses, the Government proposes, subject to further consultation, to proceed with an exemption and that this will take effect for disposals from 1 April 2002.

2.5 The broad details of the proposed exemption were set out in the July document. Most respondents commented on these and Annex B contains a summary of the main issues to emerge, together with the Government's comments. Annex B also summarises those modifications which the Government proposes as a result of this last round of consultation.

2.6 The issues that attracted most comment from respondents were:

- the 20% threshold for a substantial shareholding: whilst the draft clauses include this level for the threshold, the Government is continuing to consider this to see whether it is possible to formulate a practical test which will better identify structural holdings to which the relief should apply;
- the definitions of 'trading company' and 'trading group': the Government has decided on an activities-based definition for these terms, which will encompass activities preparatory to carrying on a trade;

- the limitation of the relief to trading companies and groups: the Government's approach to this issue is explained in Annex B.

2.7 Annex A to this Technical Note sets out draft clauses to implement the exemption and changes in respect of the degrouping charge under section 179 TCGA 1992.

**Comments are invited by 31 January 2002 on the draft clauses.**

2.8 An important aspect of the introduction of any legislative change is consideration of the regulatory burden on both business and the Inland Revenue. A partial regulatory impact assessment for the exemption is included at Annex C. The main message is that the exemption is likely to result in a slight easing of the compliance burden on companies.

**The Government would welcome comments on this partial regulatory impact assessment by 31 January 2002.**

## **Chapter 3**

### **TAXATION OF RETURNS FROM SUBSTANTIAL SHAREHOLDINGS TAXATION OF FOREIGN DIVIDENDS**

3.1 The Government considers that the exemption for capital gains on substantial shareholdings will be compatible with the existing system of taxing foreign dividends, and that this system will offer an attractive environment for business. But it recognises that there are alternative approaches to the taxation of foreign dividends, and these were considered in the July document, in response to requests from business for clarification.

3.2 Internationally, there are two accepted ways of recognising that dividends from foreign companies may have already borne foreign tax:

- charge tax on overseas dividends, but reduce this by giving a credit for foreign tax already paid. This is what the UK does currently, along with Japan, the United States and many other countries; or
- exempt from tax some dividends, in recognition of the foreign tax already paid on those dividends, while generally operating a credit regime for lowly taxed and untaxed dividends. This is, for example, what the French system does.

3.3 To aid discussion, the July document set out the Government's initial thinking about what an exemption for overseas dividends might look like were such a regime to be introduced. It made clear that:

- such an exemption should apply only to dividends paid into the UK out of profits on which a minimum level of foreign tax had been paid (on the basis that exemption is a different means of recognising foreign tax, not a means for dividends to escape tax altogether); and
- dividends that did not meet this “minimum level of foreign tax” test would be taxed in the UK, with a credit for any foreign tax suffered, just as they are now.

3.4 The July document also suggested possible ways of applying the “minimum level of foreign tax” test.

3.5 Respondents offered practically no support for the exemption outlined in the July document, and most stressed that they would much prefer to stick with the UK's existing system of taxing foreign dividends. This confirms the Government's view that the current method offers a better way forward for UK business. And the Government therefore proposes to retain that method, based around a credit for foreign tax.

3.6 Beyond that, there were four issues that attracted most comment from respondents. These are covered in turn below.

3.7 First, some respondents expressed support for a wider exemption than that set out in the July document. They accepted that the current credit regime for foreign tax would have to be retained for dividends paid to the UK by controlled foreign companies (CFCs) to meet the acceptable distribution policy exemption from the CFC rules. But they considered that there should be an exemption from UK tax for all other foreign dividends from substantial shareholdings. The Government is not attracted to this because exemption would then extend to some dividends on which little or no foreign tax had been paid.

3.8 Second, a number of respondents, including some who favoured retaining the existing regime for taxing foreign dividends in the short term, thought that the Government ought nevertheless to keep the position under review in the longer term. They stressed that many other European countries do (largely) exempt foreign dividends on substantial shareholdings, and pointed out that this might over time reduce the attractions of the UK as a location for business. The Government accepts that the treatment of foreign dividends on substantial shareholdings ought to be kept under review.

3.9 Third, many respondents suggested that the Government ought to take the opportunity to simplify the current regime for taxing foreign dividends. The Government recognises this concern, but considers – as did a number of respondents - that the new system of double taxation relief, including allowing onshore pooling of foreign dividends, that was introduced in Finance Acts 2000 and 2001 should be allowed to settle in before changes to it are contemplated. This will ensure that such changes are made in light of experience of operating the current regime, rather than before that experience has been gained.

3.10 However, to assist in the interpretation of the existing regime, the Inland Revenue has today published on its website a Statement of Practice which gives guidance on the calculation of underlying tax on foreign dividends received by companies. It covers two issues: split rate taxes and losses brought forward from previous accounting periods. A copy of that Statement of Practice is attached as Annex D.

3.11 Finally, many countries with exemption regimes for foreign dividends have rules that aim to restrict the deductibility of interest costs in respect of foreign investment. Some respondents stressed that they did not consider that any form of exemption for foreign dividends on substantial shareholdings would be desirable if that led to a restriction of interest relief on borrowings. As was made clear in the July document, the Government considers it unlikely that the proposed exemption set out in that document would necessitate the introduction of such rules.

3.12 In addition, and for clarity, it may be helpful to repeat here the other points on interest relief contained in the July document. These are that:

- the Government considers that the introduction of the exemption for capital gains on substantial shareholdings is unlikely to necessitate the introduction of rules restricting interest relief on borrowings;
- it nevertheless remains concerned that the UK's provisions for deducting interest expense should not be open to abuse and will keep the position under review.

## **Annex A**

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2. Clause 1 – Roll-over of degrouping charge on business assets
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6. Schedule 2– Exemptions for disposals by companies with substantial shareholding
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## **Commentary on draft legislation**

### **Introduction**

A.1. This commentary is intended as an aid to understanding the draft clauses and schedules which follow. However, it does not take the place of the detailed legislative provisions and reference to those must be made to gain a full understanding of what is intended.

A.2. The draft clauses and schedules set out the proposed provisions for exempting chargeable gains (and disallowing losses) realised by companies on the disposal of substantial shareholdings.

A.3. They also include the changes proposed in respect of the degrouping charge under section 179 Taxation of Chargeable Gains Act 1992 (TCGA) and the controlled foreign companies charge under section 747 Income and Corporation Taxes Act 1988 (ICTA).

A.4. The provisions are drafted as 4 clauses and two schedules. They are drafted in the modern style developed by the Tax Law Rewrite project. The order of the sections and schedules relating to chargeable gains follows that in which they will be inserted into TCGA, the changes to section 179 therefore precede the main exemption.

### **Clause 1: Rollover of degrouping charge on business assets**

A.5. This clause introduces a new section, section 179A, into TCGA which itself introduces a new Schedule, Schedule 7AB. Section 179A provides rollover relief (or holdover relief as appropriate) for gains arising by virtue of section 179 (the degrouping charge) by applying the existing business asset rollover relief provisions, as modified by Schedule 7AB .

A.6. Subsection (3) of the clause amends the regulatory-making power in section 86 Finance Act 1993, which provides for amendments to be made to the list of assets which can qualify for rollover relief, so that any necessary consequential changes can be made to Schedule 7AB in regulations.

A.7. Subsection (4) of the clause provides the commencement provisions – the intention is, subject to consultation, that claims to rollover relief can be made under the new provision where the degrouping event takes place on or after 1st April 2002.

### **Schedule 1: New Schedule 7AB to the Taxation of Chargeable Gains Act 1992**

A.8. This Schedule contains Schedule 7AB to TCGA.

## ***Schedule 7AB: Rollover of Degrouping Charge: Modification of Enactments***

### *Paragraph 1*

A.9. This sets out how sections 152 and 153 TCGA and other related provisions are to be modified solely for the purposes of the rollover relief that will apply to the degrouping charge. It defines terms by reference to section 179 TCGA, in particular company B is the company that transferred the asset intra-group to company A. It is company A which leaves the group triggering the degrouping charge.

### *Paragraph 2*

A.10. This modifies section 152, the primary rollover relief provision, and provides that

- company B must have been carrying on a trade at the time of the intra-group transfer
- the asset must have been used for the purposes of B's trade
- an amount equal to the deemed sale consideration (the market value of the asset at the time of the deemed disposal) must be invested in new assets by company A for full rollover relief to be available
- the new assets must be taken into use for the purposes of A's trade
- both the old and new assets must be within the classes of assets in section 155 TCGA
- company A must make a claim to relief.

Where these conditions are satisfied, the normal rollover consequences flow. A is treated as having disposed of the transferred asset at such amount that neither gain nor loss accrues. The acquisition cost in A's hands of the new asset is correspondingly reduced. But A's acquisition cost of the asset which has been subject to the deemed disposal and reacquisition is not reduced, otherwise there would be a double adjustment.

A.11. Sub-paragraph (3) ensures that the reinvestment period (up to 12 months before and 3 years after, or such longer time as the Board may allow) operates by reference to the time when the degrouping gain accrues. This time is later than the time when the transferred asset is deemed to have been disposed of and reacquired.

A.12. The rest of the paragraph makes detailed consequential changes to section 152 TCGA. In particular, apportionments are to be based on the use of the transferred asset whilst owned by company B.

### *Paragraph 3*

A.13. This paragraph makes corresponding adaptations to section 153 TCGA, which allows reduced rollover relief where only part of the deemed sale consideration for the transferred asset is invested by company A in new assets. The modifications to section 153 mirror those made to section 152 by paragraph 2.

### *Paragraph 4*

A.14. This modifies section 153A TCGA (which deals with provisional claims to rollover relief) for the purposes of the rollover claim on gains under section 179. It provides that company A can make a provisional claim by making an appropriate declaration in its corporation tax return for the accounting period in which the degrouping gain accrues.

### *Paragraph 5*

A.15. This paragraph modifies section 155 TCGA, which sets out the relevant classes of assets for rollover relief. It clarifies that for the purposes of determining whether the relevant asset is within Head A of Class 1, the trade referred to is the trade carried on by company B.

### *Paragraph 6*

A.16. This paragraph makes detailed consequential modifications to section 159 TCGA, the provision which restricts the availability of rollover relief in the case of claims by non-residents. It ensures that a gain cannot be rolled over into new assets that are outside the scope of UK corporation tax. The modifications ensure that the appropriate result is delivered in the case of relief for the degrouping charge.

### *Paragraph 7*

A.17. This paragraph modifies section 175 TCGA, the provision which applies rollover relief to a capital gains group.

A.18. The overall effect of the modifications is that where company A is a member of a group at the time the degrouping gain accrues and another member of that group invests an amount equal to the deemed sale consideration (the market value of the asset at the time of the deemed disposal) in a qualifying asset, company A and that other company can make a claim to rollover relief. A claim to less than full rollover can be made as appropriate if less than the full market value is invested, subject to the normal rules of section 153 TCGA (as modified for this purpose).

A.19. Sub-paragraph (4) ensures that a claim can be made if company B was not carrying on a trade at the time it transferred the asset to company A, but the asset had previously been used solely for the purposes of a trade carried on by a fellow group member.

### *Paragraph 8*

A.20. This makes a minor modification to section 185 (a company ceasing to be resident in the UK) for the purposes of rollover relief on the degrouping charge. It ensures that the provision, as modified, operates by reference to the time the degrouping gain accrues so that the gain cannot be rolled over into an asset acquired after the company ceases to be resident in the UK (unless the asset remains within the UK tax net).

### *Paragraph 9*

A.21. This makes consequential modifications to the provision (section 198 TCGA) that deals with replacement of business assets used in connection with oil fields.

### *Paragraph 10*

A.22. This makes minor consequential modifications to the tonnage tax provisions (paragraph 67 Schedule 22 Finance Act 2000).

## **Clause 2: Reallocation within group of gain or loss on degrouping**

A.23. Subsection (1) of this clause inserts a new section, section 179B, into TCGA.

### ***New section 179B***

A.24. The new section will allow a company to which a degrouping gain or loss arises (company A) under section 179 to elect jointly with another company within the same group (company C) that the gain or loss arising to company A, or part of it, shall be treated as arising to company C.

A.25. Subsection (2) of section 179B ensures that companies A and C are members of the same group at the time the degrouping gain or loss accrues and provides the mechanism for the election to transfer the gain or loss to company C. The conditions which have to be met are set out in subsections (3) to (5): company C must be resident in the UK or own assets that are within the scope of UK corporation tax on chargeable gains; neither companies A nor C can be qualifying friendly societies; nor can company C be an investment trust, a venture capital trust or a dual resident investing company.

A.26. Subsection (2) of section 179B also provides that where two or more elections are made (companies C and A, D and A etc) in respect of parts of the same gain or loss, the total amount of gain or loss reallocated does not exceed the gain or loss that would have accrued to company A.

A.27. Subsection (7) of section 179B sets the time limit for an election as two years after the end of the accounting period in which the degrouping gain accrues to company A.

A.28. Subsection (8) of section 179B directs that any payment made in connection with the election by C to A, or vice versa, is to be ignored for corporation tax purposes, provided the amount of the payment does not exceed the amount of the chargeable gain or loss.

A.29. Subsection (2) of the clause provides the commencement date for the new section: the intention is, subject to consultation, that claims to relief under section 179B TCGA can be made where the degrouping event takes place on or after 1st April 2002.

### **Clause 3: Exemption for disposals by companies with substantial shareholding**

A.30. This clause inserts a new section, section 192A, into TCGA. In turn, section 192A gives effect to a new Schedule, Schedule 7AC, to TCGA which contains most of the provisions that provide the exemptions for chargeable gains (and disallowance of losses) realised by companies with substantial shareholdings.

A.31. The intention is, subject to consultation, that the provisions will apply in relation to disposals on or after 1st April 2002.

### **Schedule 2: Exemptions for disposals by companies with substantial shareholding**

A.32. Schedule 2 contains two parts. Part 1 contains Schedule 7AC to TCGA which sets out in 33 paragraphs the detailed provisions. Part 2 contains 3 paragraphs which make consequential amendments to other provisions.

#### **Part 1 Schedule 2: New Schedule 7AC to the Taxation of Chargeable Gains Act 1992**

##### ***Part 1 of Schedule 7AC TCGA***

###### ***Paragraph 1***

A.33. This is the main exemption: a gain accruing to a company on a disposal of shares in another company is not a chargeable gain if the conditions set out in the Schedule are met. By virtue of section 16(2) TCGA, a loss is not allowable if a gain arising in equivalent circumstances would not be chargeable. The legislation makes equivalent provision for interests in shares and references to shares in this commentary are normally to be read as including interests in shares.

A.34. The paragraph also signposts the structure of Schedule 7AC: Part 2 contains the conditions that have to be satisfied by the shareholding; Part 3 the conditions that have to be satisfied by the investing company; Part 4 the conditions that have to be satisfied by the company invested in; Part 5 contains supplementary provisions.

### *Paragraph 2*

A.35. This paragraph provides a second exemption. A gain on an asset related to shares is not to be a chargeable gain where the company holds shares, a gain on which would itself be exempt under the terms of the main exemption (A.33 above). Sub-paragraph (2) covers the situation where the company which holds the related asset itself holds the shares and sub-paragraph (3) the situation where it doesn't, but shares are held by another company in its group.

A.36. The definition of an asset related to shares is in paragraph 27 Schedule 7AC (see A.86 below). An option to acquire or dispose of shares in the company is such an asset. Also included is a security that is convertible or exchangeable into those shares and an option to acquire or dispose of such a security.

A.37. So, for example, where company A holds shares in company B, a gain on which would be exempt under the main exemption if the shares were disposed of, and also holds a security which is exchangeable into shares in company B, any gain on the security is exempt under paragraph 2 Schedule 7AC (and any loss is not allowable).

### *Paragraph 3*

A.38. This paragraph contains a further exemption and is intended both to protect against exploitation of the main exemption and to exempt a gain in circumstances such as a liquidation of a company. It provides that a gain on the disposal of a substantial shareholding, or an asset related to shares, remains exempt even though certain of the other conditions are not satisfied at the time of the disposal, but were satisfied within a 2 year period prior to the date of the disposal.

A.39. Specifically, the paragraph sets out that if:

- a company meets the substantial shareholding requirement (see A.49 below) at the time of the disposal,
- a gain on that disposal would be a chargeable gain (or a loss an allowable loss),
- the company is UK resident, or, if not, any gain accruing on the disposal would form part of its chargeable profits for corporation tax purposes, and

- a gain on a hypothetical disposal within the previous two years of shares in the company invested in by the company or another group member would have been exempt (or the loss not allowable)

then the gain on the disposal is not a chargeable gain (and the loss is not an allowable loss), provided that

- if the conditions relating to the company invested in are not satisfied at the time of the disposal
- there was a time within the previous two years when the company invested in was controlled by the investing company (possibly with connected persons).

A.40. Thus, for example, where the company invested in ceases to trade on its being placed in liquidation, any gain accruing in the following 2 year period from, say, a capital distribution is potentially exempt under this paragraph. And where the trade of a company is transferred elsewhere (within a group, for example), any loss on a disposal of the shares in the company is not allowable within that 2 year period.

A.41. Sub-paragraph (3) glosses the time of the disposal if a contract is conditional: the condition is ignored so that the time of entering into such a contract is treated as the time of disposal.

A.42. Sub-paragraph (5) prevents a gain on the shares (or an asset related to shares) being exempt where value has been transferred into the company invested in during the 2 year period prior to the disposal. Otherwise for a company that has ceased trading, it would be possible to transfer a valuable asset into that company under the protection of gifts holdover relief (section 165 TCGA), sell the shares and claim that any resulting gain is exempt under Schedule 7AC.

#### *Paragraph 4*

A.43. This paragraph applies to disapply the various 'stand in shoes' provisions (share exchanges, demergers etc). Where a gain or loss would arise if those stand in shoes provisions did not operate, and the gain would not be chargeable or the loss not allowable, under the provisions of Schedule 7AC, the stand in shoes provisions are disapplied.

A.44. This provision enables shares to benefit from the exemption in circumstances where the shares or securities received in exchange may not satisfy the requirements for a gain to be exempt on a subsequent disposal. So the 'stand in shoes' provisions, if they were not disapplied, would mean that the gain on both the original shares and the consideration shares would become chargeable on the disposal of the consideration shares. By disapplying the 'stand in shoes' provisions, the company does not lose out because of the share exchange.

A.45. Sub-paragraph (2) ensures that the 'stand in shoes' provisions are not disapplied if to do so would mean that the investing company would lose investment relief under the corporate venturing scheme (CVS), and sub-paragraph (3) makes a consequential amendment to the CVS rules concerning share exchanges.

#### *Paragraph 5*

A.46. This eliminates any overlap between the exemptions under this Schedule and any other exemptions that may apply under another provision of TCGA or elsewhere.

A.47. Also the exemptions under this schedule are not to apply to a deemed disposal under section 440(1) or (2) ICTA on the occasion of the transfer of an asset between categories of business within a life insurance company.

#### **Part 2 of Schedule 7AC**

A.48. Part 2 contains the requirements that must be satisfied by a substantial shareholding.

#### *Paragraph 6*

A.49. The investing company must have held a substantial shareholding in the company invested in throughout a 12 month period beginning not more than 2 years prior to the date of the disposal. So part disposals out of a substantial holding can continue to qualify for up to 12 months after the 20% threshold (see next paragraph) has ceased to be satisfied provided all the other conditions are met.

#### *Paragraph 7*

A.50. This paragraph sets out the meaning of a substantial shareholding. The investing company must be beneficially entitled to at least 20% of the ordinary share capital of the company invested in and also at least 20% of the profits and 20% of the assets of the company available for distribution to equity holders.

A.51. The rules in Schedule 18 ICTA are imported in a slightly modified form to determine what is meant by equity holder and to determine the profits or assets available for distribution.

#### Paragraph 8

A.52. For the purposes of deciding whether a company holds a substantial shareholding, shares held by group members are aggregated (except in the case of shares held in the long-term insurance fund of a life insurance company). The aggregation applies across the world-wide group (see A.85 below for the definition of a group).

### *Paragraph 9*

A.53. This paragraph deals with the situation where there has been a no gain/no loss transfer by which the company acquired the shares. The period for which a company is treated as having held the shares is extended back through any series of no gain/no loss transfers by which the shares have arrived in the hands of the present company. The company that presently holds the shares is treated as having the entitlements provided by those shares in those prior periods.

### *Paragraph 10*

A.54. This paragraph provides explicitly that the holding period for a substantial shareholding is regarded as terminated (and a new period started) by a deemed disposal and reacquisition under any of the provisions relating to corporation tax.

### *Paragraph 11*

A.55. The effect of sale and repurchase agreements (repos) is dealt with in this paragraph. The original beneficial owner of the shares entering into a repo is treated as continuing to be the beneficial owner of the shares. By the same token, the purchasing counterparty is treated as not beneficially owning the shares during the period of the agreement.

A.56. To prevent exploitation of this provision, sub-paragraph (3) provides that where the original owner, or another member of the same group, becomes the actual beneficial owner of the shares at any time during the period the repo is current (i.e. the shares have 'gone round in a circle') the approach of paragraph 11 ceases to apply at that time.

### *Paragraph 12*

A.57. This is a companion paragraph to paragraph 11 but dealing with stock loans, rather than repos. Its approach is identical.

### *Paragraph 13*

A.58. Modifications of the basic rule for what is a substantial shareholding are contained in this paragraph for the case where the investing company is a life insurance company (or a 51% subsidiary of a life insurance company) and the shares in the company invested in are held as an asset of its long-term insurance fund. The 20% threshold is increased to 40% to ensure that the relief is properly targeted to exclude the wider range of portfolio shareholdings that life companies are likely to hold.

A.59. The need to cover 51% subsidiaries stems from the scope that there would otherwise be to hold portfolio investments indirectly through individual investment companies (so that the 40% test would be satisfied by holding the whole of that company's shares within the long-term insurance fund).

A.60. Sub-paragraph (4) provides that the rule in paragraph 8 of Schedule 7AC for aggregating holdings within a group is not to apply to shares held in the long-term insurance fund of a life insurance company which is a member of the group.

### ***Part 3 of Schedule 7AC***

A.61. Part 3 contains the requirements that must be met by the investing company.

#### *Paragraph 14*

A.62. The investing company must have been a sole trading company, or a member of a trading group, throughout the period

- beginning with the latest 12 month period (within the period of 2 years prior to the disposal) for which the company met the substantial shareholding requirement, and
- ending with the time of the disposal.

It must also be a sole trading company or member of a trading group immediately after the disposal.

A.63. A sole trading company is defined as a trading company that is not a member of a group.

A.64. Where the disposal is made under a contract, so that under section 28 TCGA the date of the disposal is the date of a binding contract (rather than the time of the actual transfer), the condition in A.62 above must also be satisfied at the time of the transfer.

#### *Paragraph 15*

A.65. This paragraph defines the terms 'trading company' and 'trading group'. The definitions are modelled on those used in Schedule A1 TCGA for CGT taper relief purposes. However, there is explicit confirmation (implicit in the taper provisions) that the trading activities of a company (or any member of the group) include those activities which it undertakes in preparing to carry on a trade.

### ***Part 4 of Schedule 7AC***

A.66. Part 4 sets out the requirements relating to the company invested in.

#### *Paragraph 16*

A.67. The company invested in must have been a qualifying trading company or a qualifying holding company throughout the period

- beginning with the latest 12 month period (within the period of 2 years prior to the disposal) for which the company met the substantial shareholding requirement, and
- ending with the time of the disposal.

It must also be a qualifying trading company or a qualifying holding company immediately after the disposal.

'Qualifying trading company' and 'qualifying holding company' are defined in paragraphs 17 and 18 Schedule 7AC (see A.69 to A.74 below)

A.68. As for the investing company, where the disposal is made under a contract, so that under section 28 TCGA the date of the disposal is the date of the binding contract (rather than the time of the actual transfer), the condition in A.67 above must also be satisfied at the time of the transfer.

#### *Paragraph 17*

A.69. Again, the definitions of qualifying trading company and qualifying holding company are modelled on those that apply for the purposes of CGT taper relief (but here with some limitations as to what constitute trading activities).

A.70. A 'qualifying trading company' means a trading company whose activities do not to any substantial extent include activities that are not qualifying activities. Qualifying activities are trading activities, except that certain trading activities qualify as trading activities only if they are carried on by a 'finance company'. A finance company is defined in sub-paragraph (4) as a company carrying on the business of banking, deposit taking etc and any similar business. Those trading activities that do not qualify if carried by a company other than a finance company are set out in paragraph 19 Schedule 7AC (see A.75 to A.76 below).

A.71. The paragraph again makes clear that activities for the purposes of a trade that the company (or a member of the group) is preparing to carry on qualify as trading activities.

#### *Paragraph 18*

A.72. A 'qualifying holding company' is defined as a company the activities of which, together with those of its 51% subsidiaries, do not to any substantial extent include activities that are not qualifying activities.

A.73. Qualifying activities are defined in the same way as in the definition of a qualifying trading company, with the appropriate changes to apply it to the group (or sub-group where the qualifying holding company is itself a subsidiary of another company). The exclusion for certain activities not carried on by finance companies applies.

A.74. Again, the provision that explicitly states that activities for the purposes of a trade that the company (or a member of the group) is preparing to carry on qualify as trading activities, is included in paragraph 18.

#### *Paragraph 19*

A.75. This paragraph sets out the financial and investment activities that do not qualify as trading activities, unless carried on by a finance company. The table in the paragraph details the excluded activities: holding securities, or dealing in securities otherwise than as a broker; holding intellectual property; leasing; investing funds that would otherwise be available for investment by a person that has control (if necessary with connected parties) of the company.

A.76. They are modelled on paragraph 9 Schedule 25 ICTA which applies for the purpose of the controlled foreign company provisions. They are considered necessary because of the relative ease by which financial investment businesses can be “dressed up” as trading.

#### **Part 5 of Schedule 7AC**

A.77. This Part contains supplementary provisions to the main requirements in Parts 2, 3 and 4.

#### *Paragraph 20*

A.78. This paragraph sets out how the requirements are to apply where there has been an earlier share exchange or scheme of reconstruction or amalgamation (within section 135 or 136 TCGA). Since the consideration shares received ‘stand in the shoes’ of the shares being surrendered, the paragraph provides that the share exchange is transparent so far as satisfying the requirements for a substantial shareholding (Part 2 Schedule 7AC) and the company invested in (Part 4 Schedule 7AC) are concerned.

A.79. For example, suppose a company holds shares in company X. Those shares are acquired by company Y in exchange for an issue of shares in company Y. The shares in company Y are sold. For the purposes of testing whether the requirements are met in relation to the substantial shareholding and the company invested in, the shareholding in Y would be examined for the period following the share exchange. The shares in X would be examined for the period prior to the exchange.

#### *Paragraph 21*

A.80. This paragraph provides equivalent treatment to that provided by paragraph 20 but where shares in a subsidiary have been demerged. For example, suppose company Z holds shares in a parent company, the parent company distributes the shares in a subsidiary to its shareholders and section 192(2) TCGA applies so that the shares in the subsidiary are treated as though they were received in a company reorganisation. When company Z subsequently sells the shares in the subsidiary, the tests of whether a

substantial shareholding has been held for the necessary period and those regarding the company invested in are applied, as necessary, to the subsidiary (back to time of the distribution) and to the parent (prior to that point).

### *Paragraphs 22 and 23*

A.81. The treatment of holdings in joint venture companies is set out in these paragraphs.

A.82. They apply where a company has a significant shareholding (more than 30% of the ordinary share capital, either by itself or together with the members of its group) in a joint venture company. Without this provision that shareholding (together with any securities held in the company) would be treated as an investment and would influence the tests as to whether the investing company is a trading company, or a member of a trading group. Also, it would influence whether a company invested in is a qualifying trading company or a qualifying holding company.

A.83. The approach of paragraph 22 (which mirrors the provisions in Schedule A1 for CGT taper relief) is to disregard the shareholding and any securities in the joint venture company and treat the company holding those shares or securities as though it were carrying on the appropriate proportion of the underlying activities of the joint venture company.

A.84. A 'joint venture company' is defined in paragraph 23 as a qualifying trading company or a qualifying holding company where there are five or fewer shareholder companies which between them are beneficially entitled to 75% or more of its ordinary share capital.

### ***Part 6 of Schedule 7AC***

#### *Paragraphs 24 to 26*

A.85. These provide interpretation of the terms used in the previous parts: company, group and related expressions (*paragraph 24*); trade (*paragraph 25*); twelve-month period (*paragraph 26*).

#### *Paragraph 27*

A.86. This paragraph sets out the meaning of an asset related to shares for the purposes of the Schedule. An option to acquire or dispose of shares in the company is such an asset. A security that is convertible or exchangeable into shares and an option to acquire or dispose of such a security are also included as assets related to shares.

#### *Paragraph 28*

A.87. This paragraph cross-references the various definitions that have appeared in the Schedule.

## **Part 7: Schedule 7AC**

A.88. This part introduces changes consequential on the main provisions.

### *Paragraph 29*

A.89. This paragraph ensures that any exemption provided by Schedule 7AC is to be disregarded in determining whether shares are 'chargeable shares' or an asset is a 'chargeable asset' for the purposes of corporation tax or capital gains tax. So, for example, shares that are within the exemption can still count as 'chargeable assets' for the purposes of the Corporate Venturing Scheme, paragraph 13 Schedule 15 FA 2000.

### *Paragraph 30*

A.90. This paragraph modifies the circumstances in which a negligible value claim can be made. The intention is that the provision will apply in relation to claims made on or after 1st April 2002. Where, owing to Schedule 7AC, an allowable loss would not accrue from a deemed disposal at the time of the claim, the company may not exercise the option (under section 24(2) TCGA) of backdating the time when the deemed disposal occurs.

### *Paragraph 31*

A.91. This paragraph applies where the charge on a gain has been postponed on the transfer of assets to a non-resident company in exchange for shares or securities of the non-resident company. Under section 140(4) TCGA the charge is postponed until the subsequent disposal of the shares or securities of the non-resident company. Without this paragraph, the postponed gain (which relates to an underlying asset, rather than the shares themselves) would also be exempt. The paragraph ensures that the postponed gain can be brought into charge.

### *Paragraph 32*

A.92. This paragraph deals with the situation where shares are appropriated by a company as trading stock. It ensures that where the gain on the shares is exempt as a consequence of Schedule 7AC, the company is treated as acquiring the shares at market value for the purposes of computing the profits of the trade to which they are appropriated.

### *Paragraph 33*

A.93. This ensures that gains held over in respect of claims to gift relief are not exempted by virtue of Schedule 7AC.

## **Part 2 Schedule 2: Consequential amendments**

### *Paragraph 2*

A.94. Part 2 of the Schedule contains one paragraph making a consequential amendment to section 241 TCGA dealing with the treatment of furnished holiday lettings. It adds Schedule 7AC to the provisions for which the commercial letting of furnished holiday accommodation is treated as a trade.

### *Paragraph 3*

A.95. This paragraph inserts a new paragraph 16 into Schedule 7B TCGA 1992, modifying paragraph 3(2)(c)(ii) of Part 1 of Schedule 7AC. Paragraph 3(2)(c)(ii) covers those assets that are chargeable assets when held by non-resident companies by referring to section 10(3) TCGA. Overseas (i.e. non-resident) life insurance companies are chargeable to tax on gains on a wider range of assets than is covered by section 10(3). The relevant rules are in section 11(2)(b) (c) and (d) of the Taxes Act 1988, and the new paragraph 16 substitutes a reference to these paragraphs of section 11(2) for a reference to section 10(3) where an overseas life insurance company is concerned.

### *Paragraph 4*

A.96. This paragraph inserts cross-references to paragraph 4 of Schedule 7AC in two corporate venturing scheme provisions which apply in certain circumstances where a company which has been invested in becomes a subsidiary of a new holding company on an exchange of shares and securities. Paragraph 84 of Schedule 15 to FA 2000 treats the share exchange as not involving a disposal of the investing company's shares in the company invested in. Paragraph 85 of that Schedule provides for the investment relief that was attributable to the investing company's shares in the company invested in to become attributable instead to the shares issued to the investing company under the exchange. These provisions will not apply in any case where paragraph 4(1) of Schedule 7AC to TCGA has effect to provide that the share exchange involves the disposal of the investing company's shares in the company invested in. Hence the need for the cross-references.

## **Clause 4: Residence status of company controlling foreign company**

A.97. Subsection (1) introduces a new subsection (1B) into section 747 ICTA to disregard, for the purposes of the controlled foreign company (CFC) provisions, section 249 Finance Act 1994. The effect is that a UK resident company that has a relevant interest in a CFC will continue to be subject to the CFC rules notwithstanding that it is treated as non-resident under the terms of one of the UK's double taxation treaties.

A.98. Subsection (2) of the clause provides that this clause shall come into force on 1 April 2002 and that it does not apply to a company that was treated

as resident outside the UK and not resident in the UK immediately before that date and has not subsequently been treated as UK resident.

## **1 Roll-over of degrouping charge on business assets**

- (1) After section 179 of the Taxation of Chargeable Gains Act 1992 (company ceasing to be member of group) insert—

### **“179A Roll-over of degrouping charge on business assets**

- (1) Where a company is treated by virtue of section 179(3) or (6) as having sold and immediately reacquired an asset at market value, relief under section 152 or 153 (roll-over relief on replacement of business assets) is available in accordance with this section in relation to any gain accruing to the company on the deemed sale.
- (2) For this purpose, sections 152 and 153 and the other enactments specified in Schedule 7AB apply with the modifications set out in that Schedule.”.
- (2) After Schedule 7AA to the 1992 Act insert the Schedule 7AB set out in Schedule 1 to this Act.
- (3) In section 86(2) of the Finance Act 1993 (roll-over relief: power to amend section 155 of the 1992 Act by order), at the end add—  
“Any such order may make such consequential amendments of Schedule 7AB as appear to the Treasury to be appropriate.”.
- (4) This section applies—
- (a) in relation to a case where a company is treated by virtue of section 179(3) of the 1992 Act as having sold and immediately reacquired an asset, where the company’s ceasing to be a member of the group in question happens on or after [1st April 2002];
- (b) in relation to a case where a company is so treated by virtue of section 179(6) of that Act, where the relevant time (within the meaning of that subsection) is on or after that date.

## SCHEDULE 1

### NEW SCHEDULE 7AB TO THE TAXATION OF CHARGEABLE GAINS ACT 1992

The Schedule inserted after Schedule 7AA to the Taxation of Chargeable Gains Act 1992 is as follows—

#### “SCHEDULE 7AB

##### ROLL-OVER OF DEGROUPING CHARGE: MODIFICATION OF ENACTMENTS

###### *Introductory*

- 1 (1) This Schedule sets out how sections 152 and 153 and other related enactments are modified for the purposes of section 179A (roll-over of degrouping charge on business assets).
- (2) In the enactments as so modified—
  - “company A” and “company B” have the same meanings as in section 179;
  - “relevant asset” means the asset mentioned in section 179A(1);
  - “deemed sale” means the sale of the relevant asset that is treated as taking place by virtue of section 179(3) or (6);
  - “deemed sale consideration” means the amount for which company A is treated as having sold the relevant asset;
  - “time of accrual” means the time at which, by virtue of section 179(4) or (8), the gain or loss on the deemed sale is treated as accruing to company A.

###### *Section 152*

- 2 (1) For subsection (1) of section 152 (roll-over relief) substitute—
  - “(1) If—
    - (a) company B was carrying on a trade at the time when it disposed of the relevant asset to company A,
    - (b) the relevant asset was used, and used only, for the purposes of that trade throughout the period when it was owned by company B,
    - (c) an amount equal to the deemed sale consideration is applied by company A in acquiring other assets, or an interest in other assets (“the new assets”),
    - (d) on acquisition the new assets are taken into use, and used only, for the purposes of a trade carried on by company A,
    - (e) both the relevant asset and the new assets are within the classes of assets listed in section 155, and
    - (f) company A makes a claim as respects the amount applied as mentioned in paragraph (c),company A shall be treated for the purposes of this Act as if the deemed sale consideration were (if otherwise of a greater amount) reduced to such amount as would secure that neither a gain nor a loss accrues to the company on the deemed sale.
- (1A) Where subsection (1) applies, company A shall be treated for the purposes of this Act as if the amount or value of the consideration for the acquisition of, or of the interest in, the new

- assets were reduced by the same amount as the amount of the reduction under that subsection.
- (1B) Subsection (1) does not affect the value at which company A is treated by virtue of section 179 as having reacquired the relevant asset.
- (1C) Subsection (1A) does not affect the treatment for the purposes of this Act of the other party to the transaction involving the new assets.”.
- (2) In subsection (2) of that section (application of subsection (1) where old assets held on 6th April 1965)—
- (a) for “subsection (1)(a)” substitute “subsection (1)”;
  - (b) for “subsection (1)(b)” substitute “subsection (1A)”.
- (3) In subsection (3) of that section (reinvestment period), for “after the disposal of, or of the interest in, the old assets” substitute “after the time of accrual”.
- (4) In subsection (5) of that section (new assets must be acquired for purposes of trade), for “the trade” substitute “the trade carried on by company A”.
- (5) In subsection (6) of that section (apportionment where part of building etc not used for purposes of trade), omit “or disposal” and insert at the end “or of the deemed sale consideration”.
- (6) After that subsection insert—
- “(6A) In subsection (6) “period of ownership”, in relation to the relevant asset, means the period during which the asset was owned by company B.”.
- (7) In subsection (7) of that section (apportionment where old assets not used for purposes of trade throughout period of ownership)—
- (a) for the words from the beginning to “period of ownership” substitute “If the relevant asset was not used for the purposes of the trade carried on by company B throughout the period during which it was owned by that company”;
  - (b) for the words from “or disposal” to the end substitute “of the asset or of the deemed sale consideration”.
- (8) In subsection (9) of that section (“period of ownership” does not include period before 31st March 1982), for ““period of ownership” does not” substitute “the references to the period during which the relevant asset was owned by company B do not”.
- (9) In subsection (11) of that section (apportionment of consideration for assets not all of which are subject of claim), omit “or disposal” and insert at the end “; and similarly in relation to the deemed sale consideration”.

### *Section 153*

- 3 For subsection (1) of section 153 (assets only partly replaced) substitute—
- “(1) If—
- (a) an amount that is less than the deemed sale consideration is applied by company A in acquiring other assets, or an interest in other assets (“the new assets”),
  - (b) the difference between the deemed sale consideration and the amount so applied (“the shortfall”) is less than the amount of the gain (whether all chargeable gain or not) accruing on the deemed sale,

- (c) the conditions in paragraphs (a), (b), (d) and (e) of section 152(1) are satisfied, and
  - (d) company A makes a claim as respects the amount applied as mentioned in paragraph (a) above,
- company A shall be treated for the purposes of this Act as if the amount of the gain accruing as mentioned in paragraph (b) above were reduced to the same amount as the shortfall (with a proportionate reduction, if not all of that gain is chargeable gain, in the amount of the chargeable gain).
- (1A) Where subsection (1) applies, company A shall be treated for the purposes of this Act as if the amount or value of the consideration for the acquisition of, or of the interest in, the new assets were reduced by the amount by which the gain is reduced (or as the case may be the amount by which the chargeable gain is proportionately reduced) under that subsection.
  - (1B) Subsection (1) does not affect the value at which company A is treated by virtue of section 179 as having reacquired the relevant asset.
  - (1C) Subsection (1A) does not affect the treatment for the purposes of this Act of the other party to the transaction involving the new assets.”.

#### *Section 153A*

- 4 (1) In subsection (1) of section 153A (provisional application of sections 152 and 153)—
  - (a) for the words from “a person” to “takes place” substitute “company A declares, in its return for the chargeable period in which the time of accrual falls”;
  - (b) for “the trade” substitute “a trade carried on by company A”;
  - (c) for “the whole or any specified part of the consideration” substitute “an amount equal to the deemed sale consideration or any specified part of that amount”.
- (2) In subsection (5) of that section (meaning of “relevant day”), for paragraphs (a) and (b) substitute “the fourth anniversary of the last day of the accounting period of company A in which the time of accrual falls”.

#### *Section 155*

- 5 In section 155 (relevant classes of assets), in Head A of Class 1, after paragraph 2 insert—

“In this head “the trade” means—

  - (a) for the purposes of determining whether the relevant asset is within this head, the trade carried on by company B;
  - (b) for the purposes of determining whether the new assets are within this head, the trade carried on by company A.”.

#### *Section 159*

- 6 (1) In subsection (1) of section 159 (new assets must be chargeable assets), for the words from “in the case of a person” to the second “in relation to him” substitute “if the relevant asset (or, as the case may be, the property mentioned in section 179(3)(b)) is a chargeable asset in relation to company

A at the time of accrual, unless the new assets are chargeable assets in relation to that company”.

- (2) In subsection (2) of that section (subsection (1) not to apply where new assets acquired by UK resident after disposal of old ones)—
  - (a) for paragraph (a) substitute—

“(a) company A acquires the new assets after the time of accrual, and”.
  - (b) in paragraph (b) for “the person” substitute “that company”.
- (3) In subsection (3) of that section (subsection (2) not to apply in certain cases where new assets acquired by dual resident), for “the person” substitute “company A”.
- (4) In subsection (6) of that section (definitions)—
  - (a) in paragraph (a) for ““the old assets” and “the new assets” have the same meanings” substitute ““the new assets” has the same meaning”;
  - (b) omit paragraph (b).
- (5) Omit subsection (7) of that section (acquisitions before 14th March 1989).

#### *Section 175*

- 7 (1) In subsection (2) of section 175 (single-trade rule for group members not to apply in case of dual resident investing company)—
  - (a) for “the consideration for the disposal of the old assets” substitute “the amount of the deemed sale consideration”;
  - (b) for ““the old assets” and “the new assets” have the same meanings” substitute ““the new assets” has the same meaning”.
- (2) In subsection (2A) of that section (claim by two group members to be treated as same person for roll-over purposes), for paragraph (a) substitute—

“(a) company A is a member of a group of companies at the time of accrual.”.
- (3) In subsection (2AA) of that section (conditions for claim under subsection (2A))—
  - (a) in paragraph (a) for the words from the beginning to “chargeable assets” substitute “that company A is resident in the United Kingdom at the time of accrual, or the relevant asset (or, as the case may be, the property mentioned in section 179(3)(b)) is a chargeable asset”;
  - (b) in paragraph (b) for “the assets” substitute “the new assets (within the meaning of section 152)”.
- (4) Immediately before subsection (2B) of that section (roll-over relief for group member not itself carrying on trade) insert—

“(2AB) Section 152 or 153 shall apply where—

  - (a) company B was not carrying on a trade at the time when it disposed of the relevant asset to company A, but was a member of a group of companies at that time, and
  - (b) immediately before that time the relevant asset was used, and used only, for the purposes of the trade which (in accordance with subsection (1) above) is treated as carried on by the members of the group which carried on a trade,

as if company B had been carrying on that trade.”.

- (5) In subsection (2B) of that section—
  - (a) omit paragraph (a);
  - (b) in paragraph (b), for “those purposes” substitute “the purposes of the trade which (in accordance with subsection (1) above) is treated as carried on by the members of the group which carry on a trade”.
- (6) Omit subsection (4) of that section (acquisitions before 20th March 1990).

*Section 185*

- 8 (1) In subsection (3) of section 185 (no roll-over relief in certain cases where company acquires new assets after becoming non-resident)—
  - (a) omit “the company”
  - (b) for paragraph (a) substitute—
    - “(a) the time of accrual falls before the relevant time; and”;
  - (c) insert “the company” at the beginning of paragraph (b).
- (2) In subsection (5) of that section (definitions), in paragraph (c) for ““the old assets” and “the new assets” have the same meanings” substitute ““the new assets” has the same meaning”.

*Section 198*

- 9 (1) For subsection (1) of section 198 (replacement of business assets used in connection with oil fields) substitute—
  - “(1) If at the time of accrual the relevant asset was used by company A for the purposes of a ring fence trade carried on by it, section 152 or 153 shall not apply unless the new assets are on acquisition taken into use, and used only, for the purposes of that trade.”.
- (2) In subsection (3) of that section (new asset conclusively presumed to be depreciating asset), for “in relation to any of the consideration on a material disposal” substitute “in a case falling within subsection (1) above”.
- (3) In subsection (5) of that section (definitions) omit paragraph (a).

*Schedule 22 to the Finance Act 2000*

- 10 In sub-paragraph (2) of paragraph 67 of Schedule 22 to the Finance Act 2000 (no roll-over relief for tonnage tax assets)—
  - (a) after “the disposal”, in the first and third places, insert “or deemed sale”;
  - (b) in paragraph (a) after “Asset No.1” insert “or, as the case may be, the deemed sale consideration”.

## **2 Reallocation within group of gain or loss on degrouping**

- (1) After section 179A of the Taxation of Chargeable Gains Act 1992 (inserted by section 1 above) insert—

### **“179B Reallocation within group of gain or loss accruing under section 179**

- (1) This section applies where—
- (a) a company (“company A”) is treated by virtue of section 179(3) or (6) as having sold and immediately reacquired an asset (“the asset”) at market value, and
  - (b) a chargeable gain or an allowable loss accrues to the company on the deemed sale.

In this section “the time of accrual” means the time at which, by virtue of section 179(4) or (8), the gain or loss is treated as accruing.

- (2) If—
- (a) company A is a member of a group at the time of accrual,
  - (b) company A and another member of that group (“company C”) make a joint election under this section, and
  - (c) the three conditions set out below are met,
- the chargeable gain or allowable loss accruing on the deemed sale, or such part of it as may be specified in the election, shall be treated as accruing not to company A but to company C.
- Where two or more elections are made each specifying a part of the same gain or loss, the total amount specified may not exceed the whole of that gain or loss.
- (3) The first condition is that, at the time of accrual, company C—
- (a) is resident in the United Kingdom, or
  - (b) owns assets that are chargeable assets in relation to it.
- (4) The second condition is that neither company A nor company C is a qualifying friendly society at the time of accrual.
- “Qualifying friendly society” here has the meaning given by section 171(5).
- (5) The third condition is that company C is not an investment trust, a venture capital trust or a dual resident investing company at the time of accrual.
- (6) A gain or loss treated by virtue of this section as accruing to a company that is not resident in the United Kingdom is treated as accruing in respect of a chargeable asset held by that company.
- (7) An election under this section must be made—
- (a) by notice in writing to an officer of the Board;
  - (b) no later than two years after the end of the accounting period of company A in which the time of accrual falls.
- (8) Any payment by company A to company C, or by company C to company A, in pursuance of an agreement between them in connection with the election—
- (a) shall not be taken into account in computing profits or losses of either company for corporation tax purposes, and
  - (b) shall not for any purposes of the Corporation Tax Acts be regarded as a distribution or a charge on income,
- provided it does not exceed the amount of the chargeable gain or allowable loss that is treated, as a result of the election, as accruing to company C.
- (9) For the purposes of this section an asset is a “chargeable asset” in relation to a company at a particular time if any gain accruing to the company on a disposal of the asset by the company at that time would be a chargeable gain and would

by virtue of section 10(3) form part of its chargeable profits for corporation tax purposes.”.

(2) This section applies—

- (a) in relation to a case where a company is treated by virtue of section 179(3) of the Taxation of Chargeable Gains Act 1992 as having sold and then reacquired an asset, where the company’s ceasing to be a member of the group in question happens on or after [1st April 2002];
- (b) in relation to a case where a company is so treated by virtue of section 179(6) of that Act, where the relevant time (within the meaning of that subsection) is on or after that date.

**3 Exemptions for disposals by companies with substantial shareholding**

- (1) In Chapter 1 of Part 6 of the Taxation of Chargeable Gains Act 1992 (provisions relating to chargeable gains of companies), after section 192 insert—

*“Disposals by companies with substantial shareholding*

**192A Exemptions for gains or losses on disposal of shares etc**

Schedule 7AC (exemptions for disposals of shares etc by companies with substantial shareholding) has effect.”.

- (2) After Schedule 7AB to that Act (inserted by section 1 above) insert the Schedule 7AC set out in Part 1 of Schedule 2 to this Act.  
Part 2 of that Schedule contains consequential amendments.
- (3) This section and Schedule 2 apply in relation to disposals on or after [1st April 2002].

## SCHEDULE 2

### EXEMPTIONS FOR DISPOSALS BY COMPANIES WITH SUBSTANTIAL SHAREHOLDING

#### PART 1

#### NEW SCHEDULE 7AC TO THE TAXATION OF CHARGEABLE GAINS ACT 1992

- 1 The following Schedule is inserted after Schedule 7AB to the Taxation of Chargeable Gains Act 1992—

#### “SCHEDULE 7AC

### EXEMPTIONS FOR DISPOSALS BY COMPANIES WITH SUBSTANTIAL SHAREHOLDING

#### PART 1

#### THE EXEMPTIONS

##### *The main exemption*

- 1 (1) A gain accruing to a company (“the investing company”) on a disposal of shares or an interest in shares in another company (“the company invested in”) is not a chargeable gain if the requirements of this Schedule are met.
- (2) The main requirements are set out in—  
Part 2 (requirement of substantial shareholding),  
Part 3 (requirements relating to the investing company), and  
Part 4 (requirements relating to the company invested in).
- (3) The requirements of those Parts are, in certain cases, qualified or extended by the supplementary provisions in Part 5.

##### *Subsidiary exemption: disposal of asset related to shares where main exemption conditions met*

- 2 (1) A gain accruing to a company (“company A”) on a disposal of an asset related to shares in another company (“company B”) is not a chargeable gain if either of the following conditions is met.
- (2) The first condition is that—  
(a) at the time of the disposal company A is beneficially entitled to shares or an interest in shares in company B, and  
(b) any gain accruing to company A on a disposal at that time of the shares or interest would, by virtue of paragraph 1, not be a chargeable gain.
- (3) The second condition is that—  
(a) at the time of the disposal company A is not beneficially entitled to shares or an interest in shares in company B but is a member of a group and another member of that group is so entitled, and  
(b) if company A, rather than that other company, were so entitled, any gain accruing to company A on a disposal at that time of the shares or interest would, by virtue of paragraph 1, not be a chargeable gain.
- (4) Paragraph 27 explains what is meant by an asset related to shares in a company.

*Subsidiary exemption: disposal of shares or related asset where main exemption conditions previously met*

- 3 (1) Where—
- (a) a company (“company A”) disposes of shares, or an interest in shares or an asset related to shares, in another company (“company B”), and
  - (b) the following conditions are met,  
any gain accruing to company A on the disposal is not a chargeable gain.  
This is subject to sub-paragraph (5).
- (2) The conditions are—
- (a) that at the time of the disposal company A meets the requirement in paragraph 6 (substantial shareholding) in relation to company B;
  - (b) that a chargeable gain or allowable loss would, apart from this paragraph, accrue to company A on the disposal;
  - (c) that at the time of the disposal—
    - (i) company A is resident in the United Kingdom, or
    - (ii) any chargeable gain accruing to company A on the disposal would, by virtue of section 10(3), form part of that company’s chargeable profits for corporation tax purposes;
  - (d) that there was a time within the period of two years ending with the disposal (“the relevant period”) when, if—
    - (i) company A, or
    - (ii) a company that at any time in the relevant period was a member of the same group as company A,  
had disposed of shares or an interest in shares in company B to which it was then beneficially entitled, a gain accruing on that disposal would, by virtue of paragraph 1, not have been a chargeable gain; and
  - (e) that, if at the time of the disposal the requirements of Part 4 (requirements in relation to company invested in) are not met in relation to company B, there was a time within the relevant period when company B was controlled by—
    - (i) company A, or
    - (ii) company A together with any persons connected with it, or
    - (iii) a company that at any time in the relevant period was a member of the same group as company A, or
    - (iv) any such company together with any persons connected with it.
- (3) In determining the relevant period for the purposes of sub-paragraph (2)(d) or (e), section 28 (time of disposal under contract) applies with the omission of subsection (2) (postponement of time of disposal in case of conditional contract).
- (4) In determining for the purpose of sub-paragraph (2)(d) whether a gain accruing on the hypothetical disposal referred to would have been a chargeable gain, the requirements of paragraphs 14(1)(b) and 16(1)(b) (requirements as to investing company or company invested in to be met immediately after the disposal) shall be assumed to be met.
- (5) Where this paragraph applies in relation to a disposal but—
- (a) immediately before the disposal company B is beneficially entitled to an asset,
  - (b) the expenditure allowable in computing any gain or loss on that asset, were it to be disposed of by company B immediately before

that disposal, would fall to be reduced because of a claim to relief under section 165 (gifts relief) in relation to an earlier disposal, and

(c) that earlier disposal took place within the relevant period,

this paragraph does not prevent a gain accruing to company A on the disposal from being a chargeable gain but any loss so accruing is not an allowable loss.

- (6) Paragraph 27 explains what is meant by an asset related to shares of a company.

*Application of exemptions in case of share reorganisation etc*

- 4 (1) For the purposes of determining whether an exemption conferred by this Schedule applies, the question whether there is a disposal shall be determined without regard to—
- (a) section 116(10) (reorganisation, conversion of securities, etc treated as not involving disposal),
  - (b) section 127 (share reorganisations, etc treated as not involving disposal), or
  - (c) section 192(2)(a) (distribution not treated as capital distribution).
- This is subject to the exception in sub-paragraph (2).
- (2) Sub-paragraph (1) does not apply to a disposal of shares if the effect of its applying would be that relief attributable to the shares under Schedule 15 to the Finance Act 2002 (corporate venturing scheme) would be withdrawn or reduced under paragraph 46 of that Schedule (withdrawal or reduction of investment relief on disposal of shares).
- (3) Where or to the extent that an exemption conferred by this Schedule does apply—
- (a) the provisions mentioned in sub-paragraph (1)(a) and (b) do not apply in relation to the disposal, and
  - (b) the provision mentioned in sub-paragraph (1)(c) does not apply in relation to the subject matter of the disposal.
- (4) Where by virtue of sub-paragraph (1) above paragraph 84 of Schedule 15 to the Finance Act 2000 does not apply in relation to a disposal of shares (that is, in a case not falling within sub-paragraph (2) above), neither does paragraph 85 of that Schedule.
- (5) In this paragraph any reference to section 127 includes a reference to that provision as applied by any enactment relating to corporation tax.

*Cases excluded from exemptions*

- 5 (1) The exemptions conferred by this Schedule do not apply—
- (a) to a disposal a gain on which would, by virtue of any enactment not contained in this Schedule, not be a chargeable gain, or
  - (b) to a deemed disposal under section 440(1) or (2) of the Taxes Act (deemed disposal on transfer of asset of insurance company from one category to another).
- (2) The hypothetical disposal referred to in paragraph 2(2)(b) or (3)(b) or paragraph 3(2)(d) shall be assumed not to be a disposal within sub-paragraph (1)(a) or (b) above.

PART 2

REQUIREMENT OF SUBSTANTIAL SHAREHOLDING

*The requirement*

- 6 The investing company must have held a substantial shareholding in the company invested in throughout a twelve-month period beginning not more than two years before the day on which the disposal takes place.

*Meaning of “substantial shareholding”*

- 7 (1) For the purposes of this Schedule a company holds a “substantial shareholding” in another company if it holds shares or an interest in shares in that company by virtue of which—
- (a) it is beneficially entitled to not less than 20% of the company’s ordinary share capital,
  - (b) it is beneficially entitled to not less than 20% of the profits available for distribution to equity holders of the company, and
  - (c) it would be beneficially entitled on a winding up to not less than 20% of the assets of the company available for distribution to equity holders.
- (2) Schedule 18 to the Taxes Act 1988 (meaning of equity holder and determination of profits or assets available for distribution) applies for the purposes of sub-paragraph (1).  
In that Schedule as it applies for those purposes—
- (a) for any reference to sections 403C and 413(7) of that Act, or either of those provisions, substitute a reference to sub-paragraph (1) above;
  - (b) omit the words in paragraph 1(4) from “but” to the end;
  - (c) omit paragraph 5(3) and paragraphs 5B to 5F; and
  - (d) omit paragraph 7(1)(b).

*Aggregation of holdings of group companies*

- 8 (1) For the purposes of paragraph 6 (the substantial shareholding requirement) a company that is a member of a group is treated—
- (a) as holding any shares or interest in shares held by any other company in the group, and
  - (b) as having the same entitlement as any such company to any rights enjoyed by virtue of holding shares or an interest in shares.
- (2) Sub-paragraph (1) is subject to paragraph 13(4) (exclusion of aggregation in case of assets of long-term insurance fund of life insurance company).

*Effect of earlier no-gain/no-loss transfer*

- 9 (1) For the purposes of this Part the period for which a company has held shares is treated as extended by any earlier period during which the shares concerned were held, or an asset from which the shares are directly or indirectly derived was held—
- (a) by a company from which the shares were transferred to the first-mentioned company on a no-gain/no-loss transfer, or

- (b) by a company from which the shares, or an asset from which the shares are directly or indirectly derived, were transferred on a previous no-gain/no-loss transfer—
  - (i) to a company within paragraph (a), or
  - (ii) to another company within this paragraph.
- (2) In sub-paragraph (1) a “no gain/no loss transfer” means a disposal and corresponding acquisition which, by virtue of any enactment relating to chargeable gains, are deemed to be for a consideration such that no gain or loss accrues to the person making the disposal.
- (3) Where sub-paragraph (1) applies to extend the period for which a company is treated as having held any shares, the company shall be treated as having had at any time the same entitlement—
  - (a) to shares, and
  - (b) to any rights enjoyed by virtue of holding shares,as the company that at that time held the shares concerned or, as the case may be, the asset from which the shares are directly or indirectly derived.
- (4) This paragraph applies in relation to an interest in shares in a company as it applies in relation to shares.

*Effect of deemed disposal and reacquisition*

- 10 (1) For the purposes of this Part a company is not regarded as having held shares throughout a period if, at any time during that period—
  - (a) a holding consisting of or including the shares concerned, or
  - (b) an asset from which such a holding is directly or indirectly derived, is deemed under any enactment relating to corporation tax to have been disposed of and immediately reacquired.
- (2) For the purposes of this Part a company is not regarded as having held an interest in shares throughout a period if, at any time during that period—
  - (a) the interest concerned, or
  - (b) an asset from which that interest is directly or indirectly derived, is deemed under any enactment relating to corporation tax to have been disposed of and immediately reacquired.

*Effect of repurchase agreement*

- 11 (1) This paragraph applies where—
  - (a) a company that is the beneficial owner of shares in another company transfers the shares under a repurchase agreement, and
  - (b) by virtue of section 263A(1) (agreements for sale and repurchase of securities) the disposal is disregarded for the purposes of the enactments relating to chargeable gains.
- (2) During the period of the repurchase agreement—
  - (a) the original owner shall be treated for the purposes of this Part as continuing to be the beneficial owner of the shares transferred and accordingly as continuing to be beneficially entitled to any rights attached to them, and
  - (b) the interim holder shall be treated for those purposes as not holding the shares transferred and as not beneficially entitled to any rights attached to them.

This is subject to the following qualification.

- (3) If at any time before the end of the period of the repurchase agreement the original owner, or another member of the same group as the original owner, becomes the beneficial owner—
- (a) of any of the shares transferred, or
  - (b) of any shares directly or indirectly representing any of the shares transferred,
- sub-paragraph (2) does not apply after that time in relation to those shares or, as the case may be, in relation to the shares represented by those shares.
- (4) In this paragraph a “repurchase agreement” means an agreement under which—
- (a) a person (“the original owner”) transfers shares to another person (“the interim holder”) under an agreement to sell them, and
  - (b) the original owner or a person connected with him is required to buy them back either—
    - (i) in pursuance of an obligation to do so imposed by that agreement or by any related agreement, or
    - (ii) in consequence of the exercise of an option acquired under that agreement or any related agreement.
- For the purposes of paragraph (b) agreements are related if they are entered into in pursuance of the same arrangements (regardless of the date on which either agreement is entered into).
- (5) Any reference in this paragraph to the period of a repurchase agreement is to the period beginning with the transfer of the shares by the original owner to the interim holder and ending with the repurchase of the shares in pursuance of the agreement.

*Effect of stock lending arrangements*

- 12 (1) This paragraph applies where—
- (a) a company that is the beneficial owner of shares in another company transfers the shares under a stock lending arrangement, and
  - (b) by virtue of section 263B(2) (stock lending arrangements) the disposal is disregarded for the purposes of the enactments relating to chargeable gains.
- (2) During the period of the stock lending arrangement—
- (a) the lender shall be treated for the purposes of this Part as continuing to be the beneficial owner of the shares transferred and accordingly beneficially entitled to any rights attached to them, and
  - (b) the borrower shall be treated for those purposes as not holding the shares transferred and as not beneficially entitled to them or to any such rights.

This is subject to the following qualification.

- (3) If at any time before the end of the period of the stock lending arrangement the lender, or another member of the same group as the lender, becomes the beneficial owner—
- (a) of any of the shares transferred, or
  - (b) of any shares directly or indirectly representing any of the shares transferred,
- sub-paragraph (2) does not apply after that time in relation to those shares or, as the case may be, in relation to the shares represented by those shares.

- (4) In this paragraph a “stock lending arrangement” means arrangements between two persons (“the borrower” and “the lender”) under which—
  - (a) the lender transfers shares to the borrower otherwise than by way of sale, and
  - (b) a requirement is imposed on the borrower to transfer those shares back to the lender otherwise than by way of sale.
- (5) Any reference in this paragraph to the period of a stock lending arrangement is to the period beginning with the transfer of the shares by the lender to the borrower and ending—
  - (a) with the transfer of the shares back to the lender in pursuance of the arrangement, or
  - (b) when it becomes apparent that the requirement for the borrower to make a transfer back to the lender will not be complied with.
- (6) The following provisions apply for the purposes of this paragraph as they apply for the purposes of section 263B—
  - (a) subsections (5) and (6) of that section (references to transfer back of securities to include transfer of other securities of the same description);
  - (b) section 263C (references to transfer back of securities to include payment in respect of redemption).

*Special rules for assets of life insurance company’s long-term insurance fund*

- 13 (1) In the following two cases paragraph 7(1) (meaning of substantial shareholding) has effect as if, in paragraphs (a), (b) and (c), “40%” were substituted for “20%”.
- (2) The first case is where the investing company is a life insurance company and the disposal is of an asset of its long-term insurance fund.
- (3) The second case is where—
  - (a) the investing company is a 51% subsidiary of a life insurance company, and
  - (b) the life insurance company holds as an asset of its long-term insurance fund shares or an interest in shares—
    - (i) in the investing company, or
    - (ii) in another company through which it owns shares in the investing company.

The reference in paragraph (b)(ii) to owning shares through another company has the same meaning as in section 838 of the Taxes Act (subsidiaries).

- (4) Where the investing company is a member of a group that includes a life insurance company, paragraph 8 (aggregation of holdings of group companies) does not apply in relation to shares or an interest in shares held by that company as assets of its long-term insurance fund.
- (5) In this paragraph—

“life insurance company” means a company carrying on life assurance business;

“life assurance business” and “long-term insurance fund” have the meanings given by section 431(2) of the Taxes Act.

PART 3

REQUIREMENTS RELATING TO THE INVESTING COMPANY

*The requirements*

- 14 (1) The investing company must—
- (a) have been a sole trading company or a member of a trading group throughout the period (“the qualifying period”)—
    - (i) beginning with the start of the latest twelve-month period by reference to which the requirement of paragraph 6 (substantial shareholding) is met, and
    - (ii) ending with the time of the disposal, and
  - (b) be a sole trading company or a member of a trading group immediately after the time of the disposal.
- (2) The requirement in sub-paragraph (1)(a) is met if the investing company was a sole trading company for some of the qualifying period and a member of a trading group for the remainder of that period.
- (3) If the disposal is by virtue of section 28(1) or (2) (asset disposed of under contract) treated as made at a time before the asset is transferred, the requirements in sub-paragraph (1)(a) and (b) must also be complied with as they would have effect if the references there to the time of the disposal were to the time of the transfer.
- (4) In this paragraph a “sole trading company” means a trading company that is not a member of a group.

*Meaning of “trading company” and “trading group”*

- 15 (1) In this Schedule—
- (a) “trading company” means a company whose activities do not to any substantial extent include activities other than trading activities; and
  - (b) “trading group” means a group the activities of whose members, taken together, do not to any substantial extent include activities other than trading activities.
- (2) In sub-paragraph (1) “trading activities”—
- (a) in relation to a company that is not a member of a group, means activities carried on—
    - (i) in the course of, or for the purposes of, a trade being carried on by the company, or
    - (ii) for the purposes of a trade that the company is preparing to carry on;
  - (b) in relation to a group, means activities carried on—
    - (i) in the course of, or for the purposes of, a trade being carried on by any member of the group, or
    - (ii) for the purposes of a trade that any member of the group is preparing to carry on.

PART 4

REQUIREMENTS RELATING TO THE COMPANY INVESTED IN

*The requirements*

- 16 (1) The company invested in must—
- (a) have been a qualifying trading company or qualifying holding company throughout the period (“the qualifying period”)—
    - (i) beginning with the start of the latest twelve-month period by reference to which the requirement of paragraph 6 (substantial shareholding) is met, and
    - (ii) ending with the time of the disposal, and
  - (b) be a qualifying trading company or qualifying holding company immediately after the time of the disposal.
- (2) The requirement in sub-paragraph (1)(a) is met if the company invested in was a qualifying trading company for some of the qualifying period and a qualifying holding company for the remainder of the period.
- (3) If the disposal is by virtue of section 28(1) or (2) (asset disposed of under contract) treated as made at a time before the asset is transferred, the requirements in sub-paragraph (1)(a) and (b) must also be complied with as they would have effect if the references there to the time of the disposal were to the time of the transfer.

*Meaning of “qualifying trading company”*

- 17 (1) In this Schedule “qualifying trading company” means a trading company whose activities do not to any substantial extent include activities that are not qualifying activities.
- (2) For this purpose “qualifying activities” means any trading activities of the company, except that the activities mentioned in paragraph 19 (certain financial and investment activities) are qualifying activities only if they are trading activities of a finance company.
- (3) For the purposes of sub-paragraph (2) the trading activities of a company are—
- (a) in the case of a company that is not a member of a group, any activities carried on—
    - (i) in the course of, or for the purposes of, a trade being carried on by the company, or
    - (ii) for the purposes of a trade that the company is preparing to carry on;
  - (b) in the case of a company that is a member of a group, any activities carried on—
    - (i) in the course of, or for the purposes of, a trade being carried on by any member of the group, or
    - (ii) for the purposes of a trade that any member of the group is preparing to carry on.
- (4) In this paragraph “finance company” means a company that is mainly engaged in banking, deposit-taking, money-lending or debt-factoring or any business similar to banking, deposit-taking, money-lending or debt-factoring.

*Meaning of “qualifying holding company”*

- 18 (1) In this Schedule “qualifying holding company” means a company whose activities together with those of its relevant 51% subsidiaries do not to any substantial extent include activities that are not qualifying activities.
- (2) For this purpose a company’s “relevant 51% subsidiaries” are those of its 51% subsidiaries that together with the company—
- (a) form a group, or
  - (b) would form a group but for the fact the company is a 51% subsidiary of another company.
- In the following provisions of this paragraph a company and its relevant 51% subsidiaries in a case falling within paragraph (b) are referred to as a “sub-group”.
- (3) For the purposes of this paragraph “qualifying activities”, in relation to a group or sub-group, means any trading activities of the group or sub-group, except that the activities mentioned in paragraph 19 (certain financial and investment activities) are qualifying activities only if they are trading activities of a member that is a finance company.
- (4) For the purposes of sub-paragraph (3)—
- (a) the trading activities of a group or sub-group are any activities carried on by any member—
    - (i) in the course of, or for the purposes of, a trade being carried on by any member, or
    - (ii) for the purposes of a trade that any member is preparing to carry on; and
  - (b) the trading activities of a member are such of the trading activities of the group or sub-group as are carried on by that member.
- (5) In this paragraph “finance company” has the same meaning as in paragraph 17.

*Qualifying activities: certain financial and investment activities*

- 19 (1) The activities referred to in paragraphs 17(2) and 18(3) as being qualifying activities only if they are trading activities of a finance company are the following:
- 1. Holding securities, or dealing in securities otherwise than as a broker. For this purpose—
    - “securities” means shares or debentures; and
    - “broker” includes a person offering to sell securities to, or to buy securities from, members of the public generally.
  - 2. Holding intellectual property. For this purpose “intellectual property” includes (in particular)—
    - (a) industrial, commercial or scientific information, knowledge or expertise;

- (b) any patent, trade mark, registered design, copyright or design right, plant breeders' rights or rights under section 7 of the Plant Varieties Act 1997;
- (c) a licence or other right in respect of intellectual property;
- (d) rights under the law of a country or territory outside the United Kingdom that correspond or are similar to those falling within paragraph (b) or (c).

3. Leasing any description of property or rights.

This does not apply to the letting of furnished holiday accommodation (within the meaning of section 504 of the Taxes Act 1988).

4. Investing, in any way, funds that would otherwise be available, directly or indirectly, for investment by or on behalf of—

As to when persons are associated with each other, see sub-paragraph (2).

- (a) a person who has control, either alone or together with other persons, of the company investing the funds, or
- (b) a person who is connected or associated with a person who has control, either alone or together with other persons, of that company.

(2) For the purposes of this paragraph the following persons are “associated with” each other—

- (a) an individual is associated with—
  - (i) his spouse, and
  - (ii) any relative, or spouse of a relative, of his or of his spouse, (“relative” meaning, for this purpose, brother, sister, ancestor or lineal descendant);
- (b) a person in his capacity as trustee of a settlement is associated with—
  - (i) any individual who in relation to the settlement is a settlor, and
  - (ii) any person associated with any such individual, (“settlement” and “settlor” having, for this purpose, the meanings given by section 660G(1) and (2) of the Taxes Act);
- (c) a person is associated with a company —

- (i) of which that person has control, or
  - (ii) of which persons associated with that person have control, or
  - (iii) of which that person and persons associated with him have control;
- (d) two or more companies are associated with each other if they are each associated with the same person by virtue of paragraph (c).

## PART 5

### SUPPLEMENTARY PROVISIONS

#### *Effect of earlier company reconstruction or amalgamation etc*

- 20 (1) This paragraph applies where shares in one company (“company X”)—
- (a) are exchanged (or deemed to be exchanged by virtue of section 136) for shares in another company (“company Y”), or
  - (b) are deemed to be exchanged by virtue of section 136 for shares in company X and shares in another company (“company Y”),
- in circumstances such that, under section 127 as it applies by virtue of section 135(3), the original shares and the new holding are treated as the same asset.
- (2) Where company Y—
- (a) is the company invested in, and is accordingly the company by reference to which the requirements of Part 2 and Part 4 fall to be met, or
  - (b) is a company by reference to which, by virtue of this paragraph, those requirements may be met, or
  - (c) is a company by reference to which, by virtue of paragraph 21 (effect of earlier demerger) those requirements may be met,
- those requirements may instead be met, in relation to times before the exchange (or deemed exchange), by reference to company X.
- (3) If in any case the requirements of Parts 2 and 4 as regards the company invested in can be met by virtue of this paragraph (or by virtue of this paragraph together with paragraph 21), they shall be treated as met.
- (4) In sub-paragraph (1) “original shares” and “new holding” shall be construed in accordance with sections 126, 127, 135 and 136.

#### *Effect of earlier demerger*

- 21 (1) This paragraph applies where shares in one company (“the subsidiary”) are transferred by another company (“the parent company”) on a demerger.
- (2) Where the subsidiary—
- (a) is the company invested in, and is accordingly the company by reference to which the requirements of Part 2 and Part 4 fall to be met, or
  - (b) is a company by reference to which, by virtue of this paragraph, those requirements may be met, or
  - (c) is a company by reference to which, by virtue of paragraph 20 (effect of earlier company reconstruction or amalgamation etc), those requirements may be met,

those requirements may instead be met, in relation to times before the transfer, by reference to the parent company.

- (3) If in any case the requirements of Parts 2 and 4 as regards the company invested in can be met by virtue of this paragraph (or by virtue of this paragraph together with paragraph 20), they shall be treated as met.
- (4) In this paragraph a “transfer of shares on a demerger” means a transfer such that, by virtue of section 192(2)(b), sections 126 to 130 apply as if the parent company and the subsidiary were the same company and the transfer were a reorganisation of that company’s share capital not involving a disposal or acquisition.

*Treatment of holdings in joint venture companies*

- 22 (1) This paragraph applies where a company (“the company”) has a significant shareholding in a joint venture company.  
For the definitions of “joint venture company” and “significant shareholding”, see paragraph 23.
- (2) If the company is not a member of a group, then, in determining whether it is a trading company or a qualifying trading company—
  - (a) its holding of shares in the joint venture company shall be disregarded, and
  - (b) it shall be treated as carrying on an appropriate proportion—
    - (i) of the activities of the joint venture company, or
    - (ii) where the joint venture company is a qualifying holding company, of the activities of that company and its 51% subsidiaries.
- (3) If the company is a member of a group, then, in determining whether the group is a trading group—
  - (a) every holding of shares in the joint venture company by a member of the group having a significant shareholding in that company shall be disregarded, and
  - (b) each member of the group having a significant shareholding in the joint venture company shall be treated as carrying on an appropriate proportion—
    - (i) of the activities of the joint venture company, or
    - (ii) where the joint venture company is a qualifying holding company, of the activities of that company and its 51% subsidiaries.

This sub-paragraph does not apply if the joint venture company is a member of the group.

- (4) If the company has one or more 51% subsidiaries, then, in determining whether it is a qualifying holding company—
  - (a) every holding of shares in the joint venture company by the company and any of its 51% subsidiaries having a significant shareholding in the joint venture company shall be disregarded, and
  - (b) the company and each of its 51% subsidiaries having a significant shareholding in the joint venture company shall be treated as carrying on an appropriate proportion—
    - (i) of the activities of the joint venture company, or
    - (ii) where the joint venture company is a qualifying holding company, of the activities of that company and its 51% subsidiaries.

This sub-paragraph does not apply if the joint venture company is a 51% subsidiary of the company.

- (5) In sub-paragraphs (2)(b), (3)(b) and (4)(b) “an appropriate proportion” means a proportion corresponding to the percentage of the ordinary share capital of the joint venture company to which the company concerned is beneficially entitled.
- (6) In this paragraph “shares”, in relation to a joint venture company, includes securities of that company or an interest in shares in or securities of that company.

*Meaning of “joint venture company” and “significant shareholding”*

- 23 (1) For the purposes of paragraph 22 a company is a “joint venture company” if, and only if—
  - (a) it is a qualifying trading company or a qualifying holding company, and
  - (b) there are five or fewer companies that between them are beneficially entitled to 75% or more of its ordinary share capital.

In determining whether there are five or fewer companies entitled as mentioned in paragraph (b), the members of a group are treated as if they were a single company.

- (2) For the purposes of paragraph 22—
  - (a) a company that is not a member of a group has a “significant shareholding” in a joint venture company if, and only if, it holds shares or an interest in shares in the joint venture company by virtue of which it is beneficially entitled to more than 30% of that company’s ordinary share capital;
  - (b) a company that is a member of a group holds a “significant shareholding” in a joint venture company if, and only if—
    - (i) it is beneficially entitled to ordinary share capital of the joint venture company, and
    - (ii) the members of the group between them are beneficially entitled to more than 30% of the ordinary share capital of that company.

PART 6

INTERPRETATION

*Meaning of “company”, “group” and related expressions*

- 24 (1) In this Schedule—
  - (a) “company” has the meaning given by section 170(9); and
  - (b) references to a group, or to membership of a group, shall be construed in accordance with the provisions of section 170 read as if “51 per cent” were substituted for “75 per cent”.

- (2) In this Schedule “51% subsidiary” has the meaning given by section 838 of the Taxes Act.

In applying that section for the purposes of this Schedule, any share capital of a registered industrial and provident society shall be treated as ordinary share capital.

- (3) References in this Schedule to a “group” or “subsidiary” shall be construed with any necessary modifications where applied to a company incorporated under the law of a country or territory outside the United Kingdom.

*Meaning of “trade”*

- 25 In this Schedule “trade” means anything that—
- (a) is a trade, profession or vocation, within the meaning of the Income Tax Acts, and
  - (b) is conducted on a commercial basis with a view to the realisation of profits.

*Meaning of “twelve-month period”*

- 26 For the purposes of this Schedule a “twelve-month period” means a period ending with the day before the first anniversary of the day with which, or in the course of which, the period began.

*Meaning of asset related to shares of a company*

- 27 (1) This paragraph explains what is meant by an asset related to shares in a company.
- (2) An asset is related to shares in a company if it is—
- (a) an option to acquire or dispose of shares or an interest in shares in that company, or
  - (b) a security to which are attached rights by virtue of which the holder is or may become entitled to acquire or dispose of (whether by conversion or exchange or otherwise)—
    - (i) shares or an interest in shares in that company, or
    - (ii) an option to acquire or dispose of shares or an interest in shares in that company, or
    - (iii) another security falling within this paragraph, or
  - (c) an option to acquire or dispose of any security within paragraph (b) or an interest in any such security, or
  - (d) an interest in any such option or security as is mentioned in paragraph (a), (b) or (c).
- (3) In determining whether a security is within sub-paragraph (2)(b), no account shall be taken—
- (a) of any rights attached to the security other than rights relating, directly or indirectly, to shares of the company in question, or
  - (b) of rights as regards which, at the time the security came into existence, there was no more than a negligible likelihood that they would in due course be exercised to a significant extent.

*Index of defined expressions*

- 28 In this Schedule the expressions listed below are defined or otherwise explained by the provisions indicated:

company	paragraph 24(1)(a)
company invested in	paragraph 1
51% subsidiary	paragraph 24(2)

group (and member)	paragraph 24(1)(b) and (3)
investing company	paragraph 1
qualifying holding company	paragraph 18(1)
qualifying trading company	paragraph 17(1)
related asset (in relation to shares)	paragraph 27
trade	paragraph 25
trading company	paragraph 15(1)(a)
trading group	paragraph 15(1)(b)
twelve-month period	paragraph 26

## PART 7

### CONSEQUENTIAL PROVISIONS

#### *Meaning of “chargeable shares” or “chargeable asset”*

- 29 Any exemption conferred by this Schedule shall be disregarded in determining whether shares are “chargeable shares”, or an asset is a “chargeable asset”, for the purposes of any enactment relating to corporation tax or capital gains tax.

#### *Negligible value claims*

- 30 (1) This paragraph applies where—
- (a) a company makes a claim under section 24(2) (assets of negligible value) in relation to shares held by it, and
  - (b) by virtue of this Schedule any loss accruing to the company on a disposal of the shares at the time of the claim would not be an allowable loss.
- (2) Where this paragraph applies the company may not exercise the option under section 24(2) to specify a time earlier than the time of the claim as the time when the shares are treated as sold and reacquired by virtue of that subsection.
- (3) This paragraph applies to—
- (a) an interest in shares in a company, or
  - (b) an asset related to shares in a company,
- as it applies to shares in that company.

#### *Recovery of charge postponed on transfer of assets to non-resident company*

- 31 (1) This paragraph applies where—
- (a) a company disposes of an asset in circumstances falling within section 140(4) (recovery of charge postponed on transfer of assets to non-resident company), and
  - (b) by virtue of this Schedule any gain accruing to the company on the disposal would not be a chargeable gain.

- (2) Where this paragraph applies the amount by which the consideration received on the disposal would be treated as increased by virtue of section 140(4) shall instead be treated as accruing to the company, at the time of the disposal, as a chargeable gain to which this Schedule does not apply.
- (3) Any reference in section 140 to an amount being brought or taken into account under or in accordance with subsection (4) of that section includes a reference to an amount being treated, by virtue of sub-paragraph (2) above, as accruing as a chargeable gain.

*Appropriation of asset to trading stock*

32 (1) Where—

- (a) an asset acquired by a company otherwise than as trading stock of a trade carried on by it is appropriated by the company for the purposes of the trade as trading stock (whether on the commencement of the trade or otherwise), and
- (b) if the company had then sold the asset for its market value, a chargeable gain or allowable loss would have accrued to the company but for an exemption conferred by this Schedule,

the company is treated for the purposes of the enactments relating to chargeable gains as if it had thereby disposed of the asset for its market value.

- (2) Section 173 (transfers within a group: trading stock) applies in relation to this paragraph as it applies in relation to section 161 (appropriations to and from stock).

*Recovery of held-over gain on claim for gifts relief*

33 (1) This paragraph applies where—

- (a) a company disposes of an asset,
- (b) the expenditure allowable in computing a gain or loss on that disposal falls to be reduced because of a claim for gifts relief in relation to an earlier disposal, and
- (c) by virtue of this Schedule any gain accruing to the company on the disposal mentioned in paragraph (a) would not be a chargeable gain.

- (2) Where this paragraph applies the amount of the held-over gain, or an appropriate proportion of it, shall be treated as accruing to the company, at the time of the disposal mentioned in sub-paragraph (1)(a), as a chargeable gain to which this Schedule does not apply.

- (3) An “appropriate proportion” means a proportion determined on a just and reasonable basis having regard to the subject matter of the disposal mentioned in sub-paragraph (1)(a) and the subject matter of the earlier disposal that was the subject of the claim for gifts relief.

- (4) In this paragraph “gifts relief” means relief under section 165 and “held-over gain” has the same meaning as in that section.”.

PART 2

CONSEQUENTIAL AMENDMENTS

*Treatment of furnished holiday lettings*

- 2 (1) Section 241(furnished holiday lettings) is amended as follows.

- (2) In subsection (3) (commercial letting of furnished holiday accommodation to be treated as trade for certain purposes), for the opening words substitute—
- “Subject to subsections (4) to (8) below, for the purposes of the provisions mentioned in subsection (3A) below—”.
- (3) After that subsection insert—
- “(3A) The provisions referred to in subsection (3) above are—  
sections 152 to 157 (roll-over relief on replacement of business asset),  
section 165 (gifts relief),  
section 253 (relief for loans to traders),  
Schedule A1 (taper relief),  
Schedule 6 (retirement relief etc), and  
Schedule 7AC (exemption in case of substantial shareholding).”.
- (4) In subsection (4) for “sections mentioned in subsection (3)” substitute “provisions mentioned in subsection (3A)”.

*Overseas life insurance companies*

- 3 In Schedule 7B (modification of Act in relation to overseas life insurance companies), after paragraph 15 add—
- “16 In Schedule 7AC, in paragraph 3(2)(c)(ii), the words “section 11(2)(b), (c) or (d) of the Taxes Act” shall be treated as substituted for the words “section 10(3)”. ”.

*Corporate venturing scheme*

- 4 In Schedule 15 to the Finance Act 2000 (the corporate venturing scheme), in paragraphs 84(1) and 85(1) after “(see paragraph 83” insert “and paragraph 4 of Schedule 7AC to the Taxation of Chargeable Gains Act 1992”.

**4 Residence status of company controlling foreign company**

- (1) In section 747 of the Taxes Act 1988 (imputation of chargeable profits and creditable tax of controlled foreign companies), after subsection (1A) insert—
  - “(1B) In determining for the purposes of paragraph (b) of subsection (1) above whether a company is a person resident in the United Kingdom, section 249 of the Finance Act 1994 (under which a company is treated as non-resident if it is so treated for double taxation relief purposes) shall be disregarded.”.
- (2) Subsection (1)—
  - (a) shall be deemed to have come into force on [1st April 2002], and
  - (b) does not apply to a company that—
    - (i) by virtue of section 249 of the Finance Act 1994 was treated as resident outside the United Kingdom, and not resident in the United Kingdom, immediately before that date, and
    - (ii) has not subsequently ceased to be so treated.

## Annex B

### **SUMMARY OF RESPONSES RECEIVED ON THE EXEMPTION REGIME FOR SUBSTANTIAL SHAREHOLDINGS PROPOSED IN THE JULY 2001 LARGE BUSINESS TAXATION CONSULTATION DOCUMENT**

B.1 Fifty-four responses were received from major corporations, representative bodies, firms of accountants and solicitors. The responses were unanimous in expressing a preference for exemption over the previously proposed deferral relief. The main reasons respondents gave for this preference were that exemption would provide greater administrative simplicity, transparency and certainty for companies. While welcoming exemption in general, many respondents went on to comment on details of the proposed relief described in the consultative document. Those issues that attracted the most comment are set out below, along with the Government's views on the points raised. (The references in brackets are to the paragraph numbers in the July 2001 consultation document.)

#### **Qualifying Shareholder Company (A.5)**

B.2 A number of respondents felt that the requirement that the shareholder company should be trading after the disposal was onerous. They were concerned that, for example, if a company briefly ceased trading or temporarily had significant cash holdings, this would prevent it from obtaining the relief.

#### ***Government View***

B.3 *The relief is targeted at the corporate sector and will facilitate commercial restructuring. Unlike the previously proposed deferral relief, there is no requirement to reinvest the disposal proceeds and the restriction of the relief to trading companies and groups is most likely to bring about a use of the proceeds which will contribute to productivity gains. The post-trading condition is necessary to prevent individuals, who may have no intention of applying the proceeds towards trading activities, from taking advantage of the relief by the simple expedient of inserting a holding company between them and their trading company before disposing of the latter.*

B.4 *The concerns about temporary spells of non-trading activity are dealt with in the next section.*

#### **Definition of Trading Company/Trading Group (A.6-A.8)**

B.5 On the issue of whether these definitions should be by reference to 'activities' or 'purposes', those respondents who commented on this were split roughly equally between the two alternatives, although most wanted the same test for both companies and groups. Some respondents raised the issue of whether disposals made in the course of a liquidation would fall within the scope of the exemption. Others felt that relief should be available to groups engaged in bona fide commercial investment business.

## **Government View**

B.6 *The Government continues to take the view that it may be very difficult in practice to ascertain the purposes of a group of companies. It has, therefore, decided that both definitions will be by reference to activities; this will provide a more objective test, with less of a compliance burden. However, it will be made clear that 'activities' here includes activities that are undertaken preparatory to the carrying on of a trade. So, while it will be a question of fact and degree in any particular case, brief periods of non-trading or the temporary holding of significant cash assets will not automatically preclude a company or group from qualifying for the relief.*

B.7 *The draft clauses published in this document contain a provision in paragraph 3 of Schedule 7AC which will have the effect that a disposal of a substantial shareholding as part of a liquidation can fall within the scope of the relief where the necessary conditions are satisfied.*

B.8 *The restriction of the relief to trading companies and groups has been explained at paragraph B.3 above.*

### **Qualifying Investee Company (A.9-A.10)**

B.9 A number of respondents thought that the trading condition was restrictive and some suggested that the relief should apply to all companies except close investment companies. Others questioned whether restrictions along the lines of paragraph 9 Schedule 25 ICTA 1988 on the meaning of trading were appropriate, particularly where they related to the holding of intellectual property.

## **Government View**

B.10 *The reason for the restriction to trading companies has been discussed at paragraph B.3 above. The rules in paragraph 9 Schedule 25 ICTA 1988 have been imported in order to prevent what are essentially investment, rather than trading, activities from being disposed of by way of a sale of shares. The Government is, of course, consulting separately on proposals for a new regime for intangible assets.*

### **What is a Substantial Shareholding? (A.11-A.14)**

B.11 There were a significant number of comments on the threshold for a substantial shareholding. Some respondents (9) were content with the 20% proposed in the consultation document. Others (16) thought a lower numerical threshold would be desirable: 10% and 5% were put forward as alternatives. The former was justified by reference to the double taxation regime and the latter was cited as the figure used in the Netherlands. A further group (7) wanted a soft test instead of/in addition to a numerical threshold: suggestions included equity accounting, treatment as fixed asset investments and board representation.

## **Government View**

B.12 *The relief is to apply to structural holdings, rather than passive portfolio holdings. Twenty per cent corresponds to the accounting rule for associated companies. It has been suggested that this may exclude some holdings which are structural in nature, particularly in joint ventures. While recognising this possibility, the Government has to strike a balance between the possibility of excluding a small number of structural holdings and including a large number of holdings which are not structural on any view. If a soft test could be identified which reliably and objectively distinguished between structural and non-structural holdings – and which did not import a great deal of complexity and uncertainty into the regime – this may be the way forward. So far the Government has unable to identify such a test.*

B.13 *The Government will consider this issue further and the draft clauses offer the opportunity for additional comment.*

## **Section 179 TCGA 1992 (A.17)**

B.14 While welcoming the extension of asset rollover relief to Section 179 gains, a number of respondents took the opportunity to comment further on Section 179. Suggestions for reform included its effective abolition, reducing the period over which it operates, an election for the Section 179 charge to fall on the vendor group and that it should only apply where there is an avoidance motive.

## **Government View**

B.15 *Although the introduction of the substantial shareholding regime was not intended as a wide-ranging review of Section 179, the Government has considered the comments made on this subject. The exemption for substantial shareholdings does not remove the charge at the asset tier and protection against ‘enveloping’ is still required. Enveloping is effective irrespective of whether there is an avoidance motive and its effectiveness is not time-limited. The Government does not, therefore, propose to amend these aspects of Section 179. However, the Government proposes an elective regime whereby a Section 179 gain can be treated as arising to other members of the vendor group. In effect, it will provide equivalent treatment to that which is available under section 171A TCGA on an actual disposal outside the group.*

## **Measures to Protect the UK Tax Base (A.21)**

B.16 A number of responses recognised that the Government needed to take action to protect the UK from tax-driven changes of residence by UK companies. There was, however, no clear preference for any one of the four options listed in para A.21 of the July 2001 consultation document. While all received at least some support, the highest number of clearly expressed preferences was for the fourth option (to exclude disposals made as part of a tax avoidance scheme) and that was less than ten.

## **Government View**

B.17 *The Government would have been content to introduce a narrowly targeted anti-avoidance rule. However, such a rule would have needed to satisfy certain criteria, including certainty, clarity, simplicity, proportionality, practicality, compliance and other resource costs for business and the IR, and conformity with wider international principles, including consistency with EU law. Indeed, the Government reviewed all the options against these demanding criteria. On this basis the second option (treaty non-resident companies remain within the UK tax rules) proved the most viable solution and is reflected in the accompanying draft clauses.*

## **Government changes following July 2001 consultation**

B.18 The consultation process included the consultation document published in July and meetings with a group drawn from a wide range of representative bodies. Following this process, the Government has been able to:

- extend the proposed definition of ‘trading activities’ so that it includes activities undertaken in preparation for the carrying on of a trade;
- extend the process of amalgamation of holdings within groups so that it applies across a world-wide 51% group;
- design a measure which will enable groups of companies to elect for gains and losses arising under section 179 TCGA 1992 (the “degrouching charge”) to accrue to other members of the vendor group, rather than the degrouching company only;
- put forward rules to protect the UK corporate tax base and to ensure symmetry of gains and losses under the proposed exemption;
- modify the proposed regime for assets held by life insurance companies in their long term business funds.

B.19 It has also been possible to clarify many of the interactions with the proposed new regime on corporate debt, financial instruments and foreign exchange gains and losses. Where shares are the subject of a financial instrument, it will generally be a question of fact as to whether those shares satisfy the tests for a substantial shareholding in the draft legislation. However, where shares are subject to stock lending or repo arrangements, it is proposed to provide for the original owner to be treated as continuing to have beneficial ownership during the period when the shares are, in fact, beneficially owned by another party. Options and convertible securities will fall within the proposed exemption regime where the holder, or another member of the holder’s group, owns shares which would benefit from the exemption on disposal.

B.20 It is proposed that North Sea holdings will be within the exemption.

## **Annex C**

# **PARTIAL REGULATORY IMPACT ASSESSMENT**

## **EXEMPTION FOR GAINS AND LOSSES ON SUBSTANTIAL SHAREHOLDINGS**

### **CONTENTS**

1. INTRODUCTION
2. PURPOSE & INTENDED EFFECT OF THE MEASURE
3. RISKS
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8. CONSULTATION
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# **PARTIAL REGULATORY IMPACT ASSESSMENT**

## **EXEMPTION FOR GAINS AND LOSSES ON SUBSTANTIAL SHAREHOLDINGS**

### **1. INTRODUCTION**

1.1 This partial Regulatory Impact Assessment sets out the costs and benefits of an exemption regime for gains and losses on disposals of substantial shareholdings which, subject to further consultation, will take effect for disposals from 1 April 2002.

### **2. PURPOSE & INTENDED EFFECT OF THE MEASURE**

2.1 At present, when groups of companies wish to restructure for commercial reasons to take advantage of emerging global opportunities in a rapidly changing world, they may face large tax charges on any resulting capital gains. This can lead to essential business decisions on restructuring and reinvestments being influenced by the tax system. It also encourages many multinational groups to put in place complex, offshore holding structures that add unnecessary administrative burdens. The exemption regime being introduced will provide business with greater flexibility in these areas.

2.2 This measure forms part of the Government's programme to create a modern, competitive and fair corporate tax regime that will provide stability for business in the longer term. The new relief will put the UK in a similar position to other countries which already operate exemption systems. For example, within the EU, Austria, Belgium, Denmark, Luxembourg, the Netherlands, Portugal and Spain already exempt capital gains on all or some classes of substantial shareholdings. The recent reforms to the German tax system have also followed this lead.

### **3. RISKS**

3.1 Without this relief the ability of UK-based groups to restructure in response to emerging global business opportunities may be constrained by the tax system. A perception that the UK corporate tax system may lead to tax considerations rather than commercial factors driving business decision-making in this area could be damaging to the attractions of the UK as a place from which to conduct international business.

3.2 Although tax is only one of many factors taken into account when multinational enterprises decide where to locate global and regional headquarters activity, it is important that the UK tax system should keep pace with changes in the global business environment. Failure to do so could mean that we might not retain significant levels of headquarters activity in the UK. There is evidence that headquarters activity brings with it a number of economic advantages, for example in terms of the provision of business services, which might be lost to the UK economy if headquarters were to move elsewhere.

## 4. OPTIONS

### *(a) No change*

4.1 One option was to make no change to the law. This would have perpetuated the risks and administrative burdens described above. The option of no change would also be inconsistent with the Government's agenda for the taxation of large business as set out in the consultation document 'Large Business Taxation: The Government's strategy and corporate tax reforms', published on 19 July 2001.

### *(b) A deferral regime*

4.2 Before putting forward proposals for exemption, the Government had consulted on the possibility of a deferral regime. Under the proposed deferral regime, gains on disposals of qualifying shareholdings would have been deferred if the sale proceeds were to have been invested in qualifying assets. Deferral would have imposed significant compliance burdens on businesses, particularly in terms of the requirement to track assets following a transaction to which the relief had applied. This tracking would have been necessary to bring the deferred gains back into charge on later disposals of the qualifying assets.

4.3 On the other hand, one advantage of deferral when compared to exemption is that it would apply only to gains. Under the deferral system proposed, where the disposal of a substantial shareholding gave rise to a loss, that loss would have been allowable in the normal way. Under the exemption system losses will not be allowable where gains arising in equivalent circumstances would not be chargeable.

### *(c) An exemption regime*

4.4 This was set out in some detail in the Large Business Taxation consultation document published on 19 July, but its effects can be summarised as follows. When a qualifying investing company disposes of a substantial shareholding in a qualifying investee company any gain arising on the disposal will be exempt, and any loss disregarded, for corporation tax purposes. Broadly, the exemption will apply where a sole trading company or a member of a trading group disposes of shares comprised in a qualifying shareholding in another trading company or the holding company of a trading group or subgroup. In order to qualify, the shareholding must meet a certain threshold (20% of the company's ordinary share capital in the draft clauses published alongside this document, but still under consideration) and have been held throughout a period of twelve months ending no earlier than twelve months before the disposal. For the purposes of deciding whether the threshold requirement has been met, the holdings of companies which are members of the same group as the investing company are aggregated.

4.5 Respondents to the 19 July consultation document were unanimous in preferring exemption to deferral. Many respondents cited the greater administrative simplicity, transparency and certainty that an exemption regime would bring among the reasons for their preference.

## **5. BENEFITS**

5.1 The direct benefit of exemption will be to trading companies or members of trading groups making gains on disposals of substantial shareholdings. These companies already need to track their shareholdings for tax and commercial purposes. They need to know what shares were acquired when and at what cost in order that they can compute gains and losses on disposal for accounts and tax purposes. They also need to be aware of the size of their holdings in order that they can apply the appropriate treatment for accounts and tax purposes generally. This information will continue to be required, but our assumption is that the proposed exemption regime will not impose any additional compliance costs or burdens. So, when making share disposals under the new regime, companies will need to draw on this information to identify which disposals qualify for the relief, having once done so they will not need to compute the resulting gain as the gain will be exempt. By the same token, the companies would not need to compute any resulting loss on the disposals although they would, of course, no longer have such losses available for offset.

5.2 This in turn means that UK-based trading groups, no longer faced with a charge on gains on substantial shareholdings, will be able to restructure more easily to respond to emerging global marketing opportunities. The new regime will not only mean that the disposal itself will produce no tax charge, but it will also reduce the need for companies and groups to undertake elaborate planning, entailing for example the adoption of complex offshore structures, to mitigate the tax effects of future share disposals. There is some evidence that it is larger groups that will benefit most from the reduced level of tax planning required, while smaller groups and companies will benefit more from the lifting of the tax charge, but the picture is by no means uniform.

5.3 The measure will put the UK into a similar position to that in a number of other countries that have exemption regimes, will provide stability for business in the longer term, and will comply with the Government's key principles of competitiveness and fairness in modernising the corporate tax system.

## **6. COSTS**

6.1 The costs will include both the compliance costs for business, the administrative costs for the Revenue and the direct Exchequer costs.

6.2 Business will receive a compliance cost saving from this measure. The Inland Revenue's 1998/9 survey of company gains suggested that about 2,000 companies made gains on substantial shareholdings in that year. Taking account of companies that might expect to make such disposals but

did not in that survey year, about 5,000 companies might expect to be directly affected by this exemption. Three-quarters of the yield on gains from share disposals came from just over 700 companies in 1998/9. This might suggest that about 1,000-1,500 companies (probably large and medium sized concerns) might be frequently disposing of substantial holdings and would have to take a structured approach to managing tax arising on such transactions and thus see a change in their compliance approach. For the remaining companies affected, gains may be dealt with on a more ad hoc basis as and when they arise. The measure, although of particular benefit to very large companies with diversified corporate structures, is also likely, perhaps less frequently, to affect a greater number of smaller concerns. Transactions in substantial shareholdings may be expected to vary significantly from year to year depending on the state of the cycle and the attractiveness of mergers and acquisitions. Consequently, there is also likely to be some variability in annual aggregate compliance costs.

6.3 There will no longer be a need to compute gains or losses on substantial holdings. There is some indication that gains on substantial shareholdings are matched by losses that companies are able to realise when such gains are in prospect. This may reflect the fact that corporate tax departments have had to ensure that assets are realised in a managed way to ensure that the effective gain charge is minimised. With the prospect of disposals of subsidiaries and other substantial holdings no longer needing such close management there is likely to be a reduced workload for corporate tax managers. There will also be savings where costs might have been incurred in using offshore structures. **The Revenue would welcome companies' views on the extent of these savings as part of this consultation.** (See below for contact point.)

6.4 For the Revenue, the reduction in administrative expenses will be small as the assessment of companies' gains will continue, albeit that some transactions are now excluded. There is an Exchequer cost from reduced Corporation Tax yield though the effective tax rate on companies' gains on substantial holdings has been relatively small. The extent of those Exchequer costs depends on the final parameters fixed for the exemption.

## **7. IMPACT ON SMALL BUSINESS**

7.1 We would particularly welcome comments from small businesses on how this measure will affect them and the extent of any compliance cost savings they anticipate. As we see it, the measure applies to all companies of whatever size. Smaller trading companies may be less likely to be realising substantial shareholdings but, for some, the benefits will be similar to those for larger corporates. Larger companies will be less fiscally inhibited from selling smaller subsidiaries to their management in cases where a MBO can lead to rejuvenation of their under-performing smaller holdings.

## **8. CONSULTATION**

8.1 There has been a wide-ranging consultation process on the design of a relief for gains on substantial shareholdings. The following consultation documents sought views from interested parties:

- Corporation Tax: Chargeable Gains-Deferral Relief for Substantial Shareholdings (23 June 2000)
- Corporation Tax: Relief for Gains on Substantial Shareholdings (8 November 2000)
- Large Business Taxation: The Government's Strategy and Corporate Tax Reforms (19 July 2001).

8.2 During this time there has also been consultation with a group drawn from interested representative bodies.

8.3 This partial RIA is issued for consultation purposes. You are invited to send comments on the points it raises. In particular views are welcome on the impact of these proposals on your business and your tax compliance costs (as discussed in paras 6.2 and 6.3). These comments will contribute to producing a final RIA. Please send comments by 31 January 2002 to the contact point below.

## **9. CONTACT POINT**

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## Annex D

### Relief for Underlying Tax: Statement of Practice

#### General

In addition to tax credit relief for direct foreign tax on a dividend, where the United Kingdom resident shareholder is a company controlling directly or indirectly not less than 10% of the voting power in the foreign company paying the dividend, it is entitled to relief for the underlying tax attributable to the dividend. This relief may be due under the terms of a double taxation agreement or, alternatively, on a unilateral basis under section 790(6) ICTA 1988.

The amount of underlying tax to be taken into account for credit relief purposes is so much as is "properly attributable" to the proportion of the foreign company's relevant profits as is represented by the dividend paid to the United Kingdom company (section 799(1) ICTA 1988).

#### A. Split Rate Taxes

Under some foreign tax systems the amount of tax charged on company profits is dependent on how much of the profits is distributed. The Inland Revenue's view is that in such circumstances the amount of tax to be taken into account in respect of a particular dividend is the actual tax charged on the portion of the profits that the dividend represents. The amount of underlying tax taken into account will therefore reflect the rate charged on the distributed profits and not the average rate of tax paid at that point on all of the relevant profits.

The Underlying Tax Group will accept computations done on either basis for dividends paid to a UK company between 31<sup>st</sup> March 2000 and 31<sup>st</sup> December 2001 inclusive.

#### Example 1

A foreign company has taxable profits of 1000, and after paying 20% company tax has relevant profits of 800. The company pays a dividend of 400 to a United Kingdom resident company. The foreign company pays additional company tax on the dividend at the rate of 10% - 40.

The amount of underlying tax to be taken into account in respect of the dividend of 400 is 140  $[(400/800 \times 200) + 40]$ .

#### Example 2

A foreign company has taxable profits of 1000, and after paying 40% company tax has relevant profits of 600. Distributed profits are taxed at 25% and on payment of a dividend of 300 to a United Kingdom resident company

the foreign company receives a dividend rebate of 100.

The amount of underlying tax to be taken into account in respect of the dividend of 300 is 100  $[(300/600 \times 400) - 100]$ . If the remaining 300 relevant profits are distributed there will be a further rebate of 100, giving underlying tax of 100, calculated in the same way.

## B. Losses

Where the foreign company that pays a dividend has accumulated losses, the Inland Revenue view's is that the relevant profits are the undistributed profits of the most recent period available at the time that the dividend was paid. The Underlying Tax Group will accept computations prepared in accordance with this or in line with previous practice for dividends paid to a UK recipient between 31<sup>st</sup> March 2000 and 31<sup>st</sup> December 2001 inclusive.

### Example 1

The accounts for a foreign company show the following results

	Year 1	Year 2	Year 3
Profits/(losses)	1000	(3000)	1500
Accumulated profits/(losses)	1000	(2000)	(500)

After the end of Year 3, it pays a dividend of 2000 out of unspecified profits.

The relevant profits are 1500 from Year 3 and 500 from Year 1.

Alternatively, if the company pays a dividend of 500 for Year 1, the relevant profits are Year 1 profits.

### Example 2

	Year 1	Year 2	Year 3
Profits/(losses)	1000	(2000)	1500
Accumulated profits/(losses)	1000	(1000)	500

After the end of Year 3 it pays a dividend of 2000 out of unspecified profits. The relevant profits are 1500 from Year 3 and 500 from Year 1.

If the dividend were paid before the end of year 3, the relevant profits would be 1000 from Year 1 and 1000 from the most recent preceding profitable period.