HMRC Guidance

Avoidance through the creation and use of capital losses by companies

27 July 2006

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This guidance is intended to be read in conjunction with the statement on capital losses published on 5 December 2005.

Draft versions of this guidance were published on 5 December 2005 and 22 March 2006. This final version of the guidance was published on 27 July 2006.

Statutory references in this note are to Taxation of Chargeable Gains Act 1992, unless otherwise indicated.

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Part 1: Introduction

1. Draft anti-avoidance legislation was published at PBR 2005 targeting arrangements that are intended to avoid UK corporation tax which involve:

    - The contrived creation of corporate capital losses (see part 3 below)
    - The buying of capital gains and losses (see part 4 below)
    - The conversion of income streams into capital gains, and the creation of a capital gain “matched” by an income deduction, where the gains are then wholly or partly franked by capital losses (see part 5 below).

2. A revised draft of the legislation was published on Budget Day, 22 March 2006. That draft, subject to a minor modification, was included in Finance Bill 2006, published on 7 April 2006. Royal Assent to Finance Act 2006 was given on 19 July 2006. The legislation applies to transactions involving capital losses which give rise to a tax advantage on or after 5 December 2005.

3. The legislation applies to any company subject to corporation tax, but, because it is targeted at arrangements that are intended to avoid UK corporation tax, most companies will not be affected, nor will it apply to the majority of transactions undertaken by companies. In particular it is unlikely that small and medium sized enterprises would be affected by these new rules because there is currently little evidence to suggest that they undertake the type of arrangements that are targeted by this legislation.

4. The arrangements this legislation is intended to affect are those that companies enter into deliberately and knowingly to avoid tax.

5. The effect of this new legislation is to restrict the use of capital losses where tax avoidance is the main purpose or one of the main purposes of the arrangements.

Part 2: Arrangements and tax advantage

6. This section provides information about the terms “arrangements” and “tax advantage” used within the new rules.

Arrangements

7. The term ”arrangements” is interpreted in the same fashion for each of the three rules. It is widely drawn to include any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable.

8. Whether a transaction forms part of a series of transactions, or a scheme, or arrangement is in general a question of fact, but this conclusion will follow in any case where one transaction would not have taken place without another transaction, or would have taken place on different terms without that other transaction. However, it is not necessary that transactions must depend on each other in this way in order that they form part of a scheme or arrangements.

Tax advantage

9. It is a common condition for each of the three rules that the main purpose or one of the main purposes in adopting an arrangement(s) was to gain a tax advantage.

10. “Tax advantage” has the meaning given in section 184D of the draft legislation. There are four legs to this definition, which cover relief, repayments, the amount of a charge, and the assessment of corporation tax. Whilst the section 184D definition applies to all of the measures described in this note, additional rules apply to the definition of tax advantage for the purposes of sections 184G and H – see Part 5 below.

11. If a tax advantage arises out of a transaction that is part of the arrangements, the legislation asks whether the main purpose or one of the main purposes of the arrangements (referred to as “a main purpose” in this guidance) is to achieve a tax advantage. The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements. If any participant has a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.

12. There is no one factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All of the circumstances in which the arrangements were entered into need to be taken into consideration. Such circumstances might include:

- the overall commercial objective (this should be considered from the perspective of not only the individual participants but also from any wider corporate group to which they belong - for these purposes a commercial objective does not include tax motivated reasons);

- whether this objective is one which the parties involved might ordinarily be expected to have, and which is genuinely being sought;

- whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional complex or costly steps would have taken place were it not for the tax advantage that could be obtained.

13. The existence of a tax advantage, such as obtaining a deduction for tax purposes, is not enough in itself to show that the arrangements have a main purpose of obtaining a tax advantage.

14. Where there is evidence that a group considered two ways to achieve a commercial objective and chose on commercial grounds to pursue one of them, the fact that there was a beneficial difference in tax treatment for the chosen route would not meet the main purpose test. Where the potential tax treatment was a factor in choosing between alternative arrangements, then it would still be necessary that securing a tax advantage was a main purpose to the arrangements. There may be situations where the tax advantage secured through undertaking one arrangement rather than another is so significant that this indicates that achieving a tax advantage was a main purpose. This is unlikely to be the case where the arrangements chosen do not involve additional, complex or costly steps included solely to secure or enhance a tax advantage.

15. Hence it will be relevant to draw a comparison in order to consider whether, in the absence of the tax considerations:

    - the transaction giving rise to the advantage would have taken place at all;

    - if so, whether the tax advantage would have been of the same amount; and

    - whether the transaction would have been made under the same terms and conditions.

16. For example, in a case where section 184A may be in point (loss buying - see Part 4 below), and the arrangements include the purchase of a company with accumulated capital losses, it will be necessary to consider whether that transaction would have proceeded at all if the company had not been in possession of capital losses. If it would, then it would also be necessary to consider, for example, whether the benefit of the capital losses had a significant effect on the terms and conditions of the acquisition.

17. Nothing in the new legislation prevents advantage being taken from the provisions in section 24 TCGA 1992 where, for example, an asset has genuinely become of negligible value. Nor will the new legislation ordinarily prevent a genuine loss on a real disposal of an asset from being used to frank gains by other companies within the same capital gains group following a claim under section 171A (unless, for example, the provisions of new section 184A apply to the loss).

Part 3: Restriction on a company's allowable losses

18. Amendments to section 8(2) TCGA 1992 and new legislation in subsections (2A) to (2C) focus on the contrived creation and realisation of capital losses.

19. There is evidence to show that a variety of schemes to generate capital losses which the existing legislation was never intended to produce are being marketed and implemented. Typically the schemes involve the generation of a capital loss for tax purposes where there is no genuine commercial loss or no genuine commercial disposal, often through schemes with no commercial rationale.

20. Thus the intent of this targeted anti-avoidance rule ("TAAR") is to apply the first of the principles set out in the HMRC statement of 5 December 2005, that relief for capital losses should only be available where a group or company has suffered a genuine commercial loss and made a real commercial disposal. This principle is neither new nor startling. Indeed, judicial support for such an approach can be found as far back as 1978:

    > "The capital gains tax is of comparatively recent origin. The legislation imposing it, mainly the Finance Act 1965, is necessarily complicated, and the detailed provisions, as they affect this or any other case, must of course be looked at with care. But a guiding principle must underlie any interpretation of the Act, namely, that its purpose is to tax capital gains and to make allowance for capital losses, each of which ought to be arrived at upon normal business principles. No doubt anomalies may occur, but in straightforward situations, such as this, the courts should hesitate before accepting results which are paradoxical and contrary to business sense. To paraphrase a famous cliché, the capital gains tax is a tax upon gains: it is not a tax upon arithmetical differences."[1]

21. This legislation will not apply where there is a genuine commercial transaction that gives rise to a real commercial loss as a result of a real commercial disposal. In these circumstances there will be no arrangements with a main purpose of securing a tax advantage. Conversely, where there is either no genuine commercial disposal, or no real commercial loss, or no real commercial disposal or any combination of the foregoing then there are likely to be arrangements in place with a main purpose, or one of the main purposes, of securing a tax advantage so the legislation will apply.

22. The effect of the new legislation is that any capital loss arising on a disposal made on or after 5 December 2005 will not qualify as an allowable loss when it arises in connection with arrangements having a main purpose of obtaining a tax advantage.

[1] Lord Wilberforce in Aberdeen Construction Group Ltd v CIR, 58 TC 281, 1978

23. In order to prevent abuse either where losses are created for immediate use or for use in future years, the legislation applies even if, at the time the loss arises, there are no chargeable gains from which the loss could otherwise have been deducted.

24. It also prevents abuse involving, for example, the transfer of assets within a group, and so applies where the tax advantage would otherwise ultimately have arisen to another company.

25. One consequence of the capital gains regime as it applies to groups of companies is that capital losses incurred in a subsidiary company may be reflected in a fall in the value of any parent company. Disposals of companies higher up the group can therefore lead to the recognition of further losses from the original loss making event; a feature known as 'tiering'. Where the original loss results from a genuine commercial loss on a genuine disposal, such that the new legislation does not apply, then to the extent that other losses are realised through the tiering effect, the same principle will apply. Conversely, if the original loss resulted from arrangements to which the legislation could apply, then subsequent losses through tiering will not be allowable losses.

26. If you are uncertain about the HMRC's interpretation of the law, HMRC will provide advice about the interpretation of legislation passed in the last four Finance Acts in accordance with the principles set out in Code of Practice 10. You should note in particular that HMRC will not give a post transaction ruling in response to applications that do not involve genuine points of doubt or difficulty to you or (if you have one) your professional adviser nor in respect of transactions which, in our view, may have been undertaken with the purpose of avoiding tax.

27. Examples of the type of scheme that this legislation will prevent are set out below.

Example 1

28. A group consists of parent company P Ltd and subsidiaries R Ltd and S Ltd. S Ltd, an investment company, is standing at a loss. P Ltd incorporates a new subsidiary T Ltd which is a company limited by guarantee. T Ltd acquires all the share capital of S Ltd, a transaction to which the provisions of section 171 cannot apply since T Ltd cannot be a member of the CG group. In the absence of the new legislation a loss accrues to P Ltd on the disposal of S Ltd to T Ltd. However, as the disposal of S Ltd takes place directly in consequence of arrangements, one of the main purposes of which is to secure a tax advantage by crystallising the loss on the investment in S Ltd, the loss accruing to P Ltd is not an allowable loss.

29. In this example the loss is not an allowable loss as the arrangements have a main purpose to secure a tax advantage. There is no real disposal of S Ltd by P Ltd since T Ltd is wholly owned by P Ltd and has been included

in the arrangements primarily because it falls outside of the capital gains group headed by P Ltd, thus triggering a disposal for tax purposes ("artificial de-grouping"). This contravenes the principle in the HMRC statement that capital loss relief should only be available where there has been a genuine commercial disposal.

Example 2

30. In this example the group also consists of companies P Ltd, R Ltd and S Ltd as above. Again, S Ltd is standing at a loss, but the group does not wish to dispose of its investment which it views as long term. Arrangements are entered into under which S Ltd is disposed of to a bank, thus crystallising the loss. Within a week, S Ltd is reacquired by P Ltd.

31. The intention (or one of the intentions) of the group is to secure access to the loss it has incurred on its investment in S Ltd, even though there is no intention to divest itself of its investment. Prior to the repeal of section 106 the acquisition of S Ltd by P Ltd would be matched with the disposal a week earlier, with the effect that the loss would not crystallise. In this example the group has not made any real commercial disposal of S Ltd to realise the loss as it was always the intention to reacquire. It thus contravenes the first principle in the HMRC Statement of 5 December.

32. In this case it is evident that arrangements to reacquire S Ltd were in place given the short time span between disposal and reacquisition. Following the enactment of TAAR1, any loss accruing to P Ltd on the disposal of S Ltd in pursuance of arrangements would not be an allowable loss.

Example 3

33. Y plc is the principal company of a property group that includes a subsidiary company X Ltd. X Ltd owns a property in the centre of London with a base cost of £1bn. The property was previously acquired from a fellow group company at no gain/no loss[2] when the market value of the property stood at £900m. X Ltd issues shares to an unconnected party, B Ltd, to the extent that B Ltd holds 30% of the issued share capital of X Ltd and so X Ltd is no longer a member of the Y plc group. These new shares have very restricted rights compared to those already in issue.

34. In the absence of the new legislation the fact that X Ltd is no longer part of the group headed by Y plc triggers the degrouping provisions, and a capital loss is realised, reflecting the previous fall in property value of £100m.

35. This is an example of artificial degrouping by issuing shares in a subsidiary company to a third party. In this example, although Y plc has suffered from a real fall in the value of its subsidiary, X Ltd, as a result of changes in the property value, it has not made a real commercial disposal of the subsidiary to realise that loss. The presence of only very restricted rights

[2] Under section 171(1)

attached to the new shares indicates that Y plc has no intention of making any material disposal of its economic interest in the property. Following the enactment of TAAR1, any loss accruing to Y plc in pursuance of arrangements will not be an allowable loss.

36. The issue of shares with very restricted rights to a third party is an arrangement that the new legislation would affect because this transaction was undertaken primarily to secure a tax advantage, being the recognition of a capital loss through the operation of the 'de-grouping' provisions. New section 8(2A) provides that this loss arises in disqualifying circumstances and is not therefore an allowable capital loss.

37. If, however, in the above example B Ltd genuinely wished to enter into a joint venture involving the property, then a different outcome can be expected. It would have subscribed for shares that had rights comparable to those in issue, so that it acquired a corresponding share of the economic value of X Ltd. In those circumstances, securing a tax advantage is unlikely to have been a main purpose of the transaction.

Example 4

38. Losses sometimes arise on the occasion of the liquidation of a group company.

39. The liquidation of a subsidiary company that had suffered a real economic loss, say on the failure of a construction project joint venture, would be unlikely to be caught by the legislation. The existence of a bona fide commercial activity, the involvement of a genuine unconnected party in the venture, and explicit mention of the demise of the venture in the parent company's published accounts would indicate that arrangements to secure a tax advantage were not a main purpose. The resultant loss would not be disallowed by the new legislation, even if the company chose to liquidate the company at the same time as a chargeable gain arose elsewhere in the group, in order that advantage could be taken of section 171A in the manner in which it was intended to be used.

40. On the other hand, where a group has knowingly taken steps to ensure that the loss on the liquidation of a subsidiary is not representative of a genuine commercial loss, perhaps by using the type of transactions that are mentioned in example 1, it is likely that the arrangements would be caught by the new legislation.

41. The same principles would apply in the event that a group decides to have a subsidiary company struck off, rather than to carry out the full liquidation process.

Commencement

42. Where the legislation applies, it will take effect to disallow losses that arise on disposals made on or after 5 December 2005.

Part 4: Restriction on buying gains and losses

43. Legislation to restrict the set off of pre-entry losses and the set off of losses on pre-entry gains was introduced in the 1990s. There is evidence to show that schemes designed to deliberately circumvent the intention of the existing legislation in Schedule 7A (for loss buying) and Schedule 7AA (for gain buying) are being marketed and implemented. New rules in sections 184A to F are being introduced which will supplement the existing rules in Schedule 7A in relation to loss buying, and replace the existing rules in Schedule 7AA for gain buying.

44. The existing legislation at Schedule 7A TCGA 1992 will remain applicable in all cases that do not involve tax avoidance, including the vast majority of mergers and acquisitions. But where there is a tax avoidance purpose, the new rules take effect in priority to the existing provisions.

45. The legislation designed to prevent gain buying is less effective following the introduction of the substantial shareholdings exemption. Section 184B therefore replaces Schedule 7AA TCGA 1992 enabling Schedule 7AA TCGA 1992 to be repealed.

46. Thus the intent of this targeted anti-avoidance rule is to apply the second of the principles set out in the HMRC statement of 5 December 2005, that in general, a company's capital losses should only be available against its own capital gains or those of companies that were under the same economic ownership when the loss arose and when the loss is utilised.

47. The new rules will apply whenever there is a change of ownership of a company ("the relevant company") that occurs directly or indirectly in consequence of, or in connection with arrangements. Where a main purpose of the arrangements is to secure a tax advantage involving the deduction of a capital loss from any chargeable gains, then that loss may not be deducted from the gains.

48. "Change of ownership" means that a company either becomes a member of a group of companies, or ceases to be a member of a group of companies, or becomes subject to different control. The wide definition of "change of ownership" is designed to prevent artificial arrangements under which, for example, a company's membership of a group changes for tax purposes when the economic reality is that it does not. However HMRC would not normally consider the incorporation of a company or the acquisition from a company formation agent of a newly formed company as amounting to a change of control.

49. The effect of the legislation in relation to loss buying is that a loss which arises to a company on a disposal of a pre-change asset may not be set against any gains, except in certain very limited circumstances. Similarly, the effect of the legislation in relation to gain buying is that losses may not be set against gains except in certain very limited circumstances. A "pre-change asset" is defined as an asset owned by the relevant company

before the change of ownership. There are specific rules to ensure the continuity of identification of a pre-change asset where gains and losses on such assets are deferred or rolled over by virtue of the application of various other provisions in TCGA 1992.[3]

50. The new loss buying rules take effect whether or not the loss arises before, at the same time as, or after, the change of ownership, and whether or not there is a chargeable gain from which it may be deducted at that time. The new legislation also applies whether or not the tax advantage arises to the company that has changed ownership or to another connected company. This prevents the rules from being circumvented, for example, by the transfer of assets within a group.

51. The gain buying rules take effect whether or not the gain arises before, at the same time as or after the change of ownership, and whether or not there is an allowable loss which can be set against the gain at that time. Once again the tax advantage can arise to the company that has changed ownership or to another company.

52. The limited circumstances in which the new loss buying provisions do not prevent access to a loss is where the loss is set against a gain which arises to a company on the disposal of an asset it either disposed of, or owned, prior to the change of ownership. Similarly, the new gain buying provisions do not prevent the set off of a loss on an asset disposed of by the company which changed ownership provided the asset that gave rise to the gain was disposed of before the change of ownership, or the asset was owned by the company before the change of ownership and disposed of subsequently.

53. In the unlikely event that an identification issue arises in relation to the set off of earlier losses where some are not caught by the new legislation but others are, then the set off may be effected in the manner most beneficial to the taxpayer.

54. If you are uncertain about the HMRC's interpretation of the law, HMRC will provide advice about the interpretation of legislation passed in the last four Finance Acts in accordance with the principles set out in Code of Practice 10. You should note in particular that HMRC will not give a post transaction ruling in response to applications that do not involve genuine points of doubt or difficulty to you or (if you have one) your professional adviser nor in respect of transactions which, in our view, may have been undertaken with the purpose of avoiding tax.

Example 5

55. Singleton company, B Ltd, has substantial capital losses. B Ltd also owns a property that it is in negotiations to sell. B Ltd issues ordinary shares to third party X with a nominal value that amounts to more than 25% of the

[3] See s.184E, subsections (7) to (9).

total nominal value of the ordinary share capital of B Ltd. Typically these shares will have no rights other than to a very small dividend. The original shareholders then sell the original shares in B Ltd to C group. In economic terms B Ltd has joined the C group but it has not joined the C chargeable gains group because the C group owns less than 75% of the issued share capital of B Ltd[4]. The C group would then intend to transfer all of its assets that have not yet risen in value, but that it expects to rise in value to B Ltd in the expectation that any resulting chargeable gains could be covered by purchased losses.

56. The issues of shares in B Ltd to a third party is clearly intended to prevent B Ltd joining the C group when the original shareholders sell their shares. This prevents the rules in Schedule 7A applying.

57. In this example, the loss has accrued in a different economic entity to the one which seeks to use it. The second principle in the HMRC statement of 5 December 2005 has been breached. B Ltd has neither left nor joined a chargeable gains group but it has become subject to different control. There has therefore been a qualifying change of ownership[5]. B Ltd has accrued losses on pre-change assets. The change of ownership has occurred in connection with arrangements, the main purpose of which is to secure a tax advantage for the C group. Section 184A(2) therefore applies and the losses of B Ltd are qualifying losses and are not to be deducted from any gains arising to the company, except those accruing to B Ltd on a disposal of pre-change assets. If the property owned by B Ltd at the time of the change of ownership is then sold giving rise to a chargeable gain, this gain can be covered by the losses.

Example 6

58. Group A holds all of the share capital of B Ltd. B Ltd owns all of the shares in C Ltd. Apart from the shares in C Ltd, B Ltd holds no significant assets or business. B Ltd's holding in C Ltd stands at a loss. A then sells the shares in B Ltd to X group. B Ltd then disposes of the shares in C Ltd realising a capital loss. X group would then expect to transfer any assets within the group that are standing at a gain to B Ltd at no gain/no loss[6] before disposing of these assets outside the group. (Under the terms of the existing legislation a proportion of the loss that arose on the disposal of C Ltd by B Ltd would not be regarded as pre-entry, even though the economic loss was wholly sustained prior to the disposal of B Ltd by the A Group.)

59. This is a clear example of loss buying occurring in spite of the existing legislation, which might occur where the purchasing group is content that it will only be able to access a part of the losses sustained on the disposal of C Ltd. Again, the second principle set out in the HMRC statement of 5

[4] See section 170(3)
[5] as defined by section 184C(1)
[6] Either under section 171(1), or achieve the same effect though an election under section 171A(2)

December 2005 has been infringed. There has clearly been a qualifying change of ownership as defined in section 184C. B Ltd has accrued losses on the disposal of a pre-change asset. One of the main purposes of the change in ownership was to secure a tax advantage. Section 184A therefore applies and the qualifying loss cannot be deducted from any gains made by X group.

60. If, before the shares in C Ltd were disposed of, they were transferred to another member of the X group, Y Ltd, at no gain, no loss[7], the capital loss would then arise to Y Ltd. However, section 184C applies and it would still be a qualifying loss as it has arisen to a company on a pre-change asset. The loss cannot therefore be deducted from any chargeable gains of Y Ltd.

Example 7

61. Group A owns all of the share capital of company B Ltd that in turn owns a business with substantial intangible property. The intangible property does not qualify for amortisation relief[8] as it was held by B Ltd prior to 1 April 2002. If A sells the share capital in B Ltd it would realise a substantial gain covered by the substantial shareholding exemption. Company C Ltd wishes to buy the business of B Ltd but not B Ltd itself, as C Ltd wishes to obtain the amortisation relief made available when intangible property is acquired after 1 April 2002.

62. Group A sells its share capital in B Ltd to company X Ltd, which has substantial capital losses available. A has thus made a gain that is exempt under the substantial shareholdings rules. X Ltd then arranges for the sale of the business of B Ltd including the intangible property to C Ltd, hoping that its losses can be deducted from the gain arising.

63. This is clear example of gain buying that would not have been prevented by Schedule 7AA TCGA, which applied up to 5 December 2005. The second principle in the HMRC statement has been contravened. X Ltd only becomes a participant in the scheme because it has surplus capital losses that it is willing to make available[9]. The intended result is that the capital losses of X Ltd will be used to reduce the gain that arises when the trade of B Ltd is sold from Group A to C Ltd. There has clearly been a qualifying change of ownership as defined by section 184C. A gain has arisen to company B on the disposal of a pre-change asset. The change in ownership has occurred in connection with arrangements the main purpose of which is to secure a tax advantage. Section 184B provides that the gain may not be franked by a loss.

Example 8

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[7] Either under section 171(1), or achieve the same effect though an election under section 171A(2)
[8] Under Schedule 29 FA 2002
[9] Using section 171A

64. It is not intended that ordinary merger and acquisition activity will be affected by the existence of this provision in any way. For example, a company with an ongoing trade is acquired by A group from B group. The company that has changed hands has capital losses brought forward which, say, arose in 1998 on the disposal of its interest in a failed joint venture. If, for example, it is clear that A group has made the acquisition because the trade fits well with other businesses already owned and that the Directors of A group believe that its profitability can be improved, the new legislation will not operate to disallow the capital losses, and those losses will be subject to the rules in Schedule 7A as normal. In these circumstances the new legislation, when enacted, will not apply as the change of ownership does not occur directly or indirectly in consequence of arrangements the main purpose, or one of the main purposes, of which is to secure a tax advantage.

65. However, it may be the case that the existence of the capital losses is a material factor in the acquisition, even though there is a genuine acquisition of a trade as well, and that particular steps have been introduced to the arrangements in order to prevent the application of Schedule 7A. In these circumstances securing a tax advantage could be one of the main purposes of the arrangements, in which case access to the losses will be restricted.

Commencement.

66. The new provisions in sections 184A to F apply where a tax advantage arises on or after 5 December 2005. This can include situations where a loss arose prior to 5 December, but where the gain that it might otherwise have reduced arises on or after that date.

67. HMRC recognise that there may be some situations where a company has had a qualifying change of ownership within the meaning given by section 184C, where there was an intention of securing a tax advantage from the crystallisation of capital losses before this legislation came into force but where there was no intention to buy and sell capital losses or gains that arose in different ownership. These are not therefore cases that sections 184A or 184B are intended to affect.

68. HMRC is aware that such schemes were being used by groups that wished to recognise a capital loss for tax purposes without losing control of the company that owns the relevant assets or the assets themselves. The changes described in Part 3 of this note are intended to deter this type of activity from 5 December 2005 by providing that such losses are not allowable losses for tax purposes. It has become apparent since the publication of the draft legislation that TAAR 2 can also apply under such circumstances where the transactions occurred before 5 December 2005. Consequently, there is a transitional provision to ensure that TAAR 2 does not restrict the use of losses realised prior to 5 December 2005 where a qualifying change of ownership before that date involves a company ceasing to be a member of a group. However, the principal member of that

group must retain control of the company at all times, and may not join another group (except where a new holding company is inserted above it).

Example 9

69. This is best demonstrated by an example. Group A is made up of A plc, its 100% subsidiaries B Ltd and C Ltd and its 100% subsidiary X Ltd, a company limited by guarantee. In March 2002 (i.e. prior to 5 December 2005), A plc disposes of 76% of its interest in B Ltd to X Ltd. Because of earlier asset transfers to which section 171 applied, the de-grouping provisions apply which crystallise a loss in B Ltd. An election is made under section 179A for the loss to be deemed to accrue in C Ltd.

70. In the circumstances set out above the loss accruing to C Ltd may be used to frank subsequent gains on assets accruing to A Ltd or C Ltd.

Part 5: Schemes converting income to capital and schemes securing deductions

71. The intent of this targeted anti-avoidance rule is to apply the third of the principles set out in the HMRC statement of 5 December 2005, that apart from certain restricted circumstances, capital loss relief is only available against capital gains, and not income profits.

72. Unlike the other measures being introduced as part of this package this rule primarily provides protection against future schemes, which aim to use capital losses to reduce income profits.

73. There has been a steady but significant emergence of “conversion” schemes in recent years, and HMRC has addressed these through specific legislation targeting individual or closely allied schemes. The legislative solutions have generally operated to treat all or part of the consideration that would otherwise be taken into account in computing a chargeable gain, as an income receipt. One example of such a measure is sections 91A-G FA 1996, introduced by Paragraph 10 Schedule 7 of Finance (No2) Act 2005, which addressed schemes designed to provide an interest-like return in the form of profits from the holding of shares.

74. However HMRC is aware that a large amount of unused capital losses is potentially available to companies, and this fact, combined with experience to date, suggest that there is likely to be increased activity in this area. This poses a significant risk not only to corporation tax on future capital gains, but also to corporation tax on companies’ income profits. This rule is therefore being introduced to prevent further avoidance activity in this area.

75. There are two routes by which capital losses can be used to reduce income profits:

- Where an amount that would otherwise be chargeable to corporation tax as income is treated as a capital item through the implementation of the arrangements.

- Where arrangements are put in place that involve a company realising a capital gain, and as part of the arrangements the company, or a related company, also incurs expenditure that gives rise to a deduction in computing its income or total profits chargeable to corporation tax.

76. In either case corporation tax on the gain is intended to be covered by capital losses, at least in part, as part of the arrangements.

77. Sections 184G to 184H deal separately with the two types of behaviour that are being addressed by the new measure. Section 184I covers matters in connection with the issue of notices directing the application of the legislation in cases where HMRC have a reasonable belief that the relevant conditions apply.

78. An informal clearance procedure is available in relation to the operation of sections 184G to H. Note that these procedures are not available in relation to the other anti-avoidance measures introduced at PBR 2005 described in this note.

Section 184G

79. Section 184G deals with schemes that convert income into capital. Subsection (1) sets out the basic conditions which need to be met before the legislation will apply. In addition the legislation will only apply where HMRC has issued a notice to that effect, as described below.

80. The rule is intended to target those arrangements that include both of the following in order to secure a tax advantage as a main purpose:

- An amount that would otherwise have been accounted for tax purposes as income has been converted to a capital sum.
- That capital sum gives rise to a chargeable gain, which it was intended would be reduced by capital losses

81. Whilst there is no requirement that the capital receipt be identical in amount or timing to the income that would have arisen in the absence of the arrangements, it is clear that it should represent that income. In some cases, the accounting treatment may clearly demonstrate the link, in that what for tax purposes is a capital receipt, is shown in the company accounts as income.

82. Where both section 184G and existing anti-avoidance rules could potentially apply to the same transaction, double taxation will not arise (for example through the restriction of losses used against a capital gain and re-characterisation of all or part of the consideration as an income profit). This is because section 37(1) acts to disregard, in computing the amount of the consideration for chargeable gains purposes, any amount taken into account in computing the income of the person making the disposal.

83. For the purposes of section 184G, the definition of tax advantage in section 184D applies, but the tax advantage must also involve the deduction of losses from the relevant gain.

Section 184H

84. Section 184H deals with schemes involving deductions, where arrangements are put in place with the intention of using capital losses to reduce a chargeable gain, and as a consequence of the transaction which produced the gain, the company, or a connected company, incurs expenditure that reduces its income profits chargeable to corporation tax.

85. Again it is necessary, if the legislation is to apply, for there to be arrangements that tie in the realisation of a gain, the expenditure incurred, and the use of losses to reduce the gain, to secure a tax advantage.

86. The legislation includes provision for certain common commercial transactions to be excluded from consideration. These are arm's length sale and leaseback transactions involving land where there is no connection between the lessor and the lessee. Whilst it would seem unlikely that such transactions would amount to arrangements where there was a main purpose of securing a tax advantage, the exclusion has been provided to eliminate any uncertainty. The exclusion does not mean that other types of sale and leaseback between unconnected parties will necessarily be caught by the new rules. Nor does it mean that all such arrangements between connected parties will be caught. Taxpayers should in such cases be guided by the information given in this document that the rules are targeted at arrangements where a main purpose was to secure a tax advantage through the use of capital losses in ways that reduce income profits.

87. For the purposes of section 184H, the definition of tax advantage in section 184D applies, but the tax advantage must also involve both the deduction of expenditure in calculating total profits, and the deduction of losses from the chargeable gain.

Some arrangements the new legislation will not catch

88. This measure is targeted at contrived arrangements that seek to use capital losses to reduce income profits; it is not intended that it will be used to restrict companies' ability to make use of normal commercial practices which may happen to have some characteristics in common with the targeted arrangements.

89. As already mentioned above it is unlikely that normal sale and leaseback transactions, used by companies to provide funding for their business from an unconnected third party, will be caught i.e., the fact that a company incurs an ongoing rent charge, deductible against its profits, will not in itself be enough to bring the arrangements within the legislation. There would need to be a tax avoidance main purpose and in this situation it is unlikely that this would be present.

90. As mentioned above additional certainty is provided by the legislation as there is an explicit carve out for the sale and lease back of real property with unconnected parties. Where similar commercial considerations apply, then HMRC will follow this practice in similar transactions, unless there are other factors to the arrangements that suggest the use of capital losses is integral to obtaining a wider tax advantage.

Notices

91. Section 184G and H notices may be issued before or after a self assessment return is made and (exceptionally) may be made on a discovery basis after the return enquiry window has closed (see below). In order to ensure consistent application of the legislation, the HMRC Commissioners intention is to retain responsibility for the issue of notices centrally.

92. The only effect of the notice is to switch on the legislation in relation to the arrangement(s).

93. HMRC will only issue a notice in a case under section 184G(2) when it is considered on reasonable grounds that all the following apply:

- A gain arises to a participant in the arrangements,
- That gain effectively represents a sum that, in the absence of the arrangements, would have been receivable in a form charged to tax as income, either on the same company or a connected person,
- As part of the arrangements the gain would, but for this legislation, have been reduced by allowable losses,
- It was the main purpose, or one of the main purposes of the arrangements to achieve the conversion of the income to a capital sum.

94. HMRC will only issue a notice in a case under section 184H(6) when it is considered that all of the following apply:

- A gain arises to a participant in the arrangements,
- The gain would, but for this legislation, have been reduced by allowable losses,
- As a consequence of the arrangements that gave rise to the gain, a party to those arrangements incurs expenditure that reduces the profits chargeable to corporation tax, which, absent the arrangements, it would not have incurred,
- It was the main purpose, or one of the main purposes, of the arrangements to secure the reduction in those profits.

95. After a return has been made, a notice may only be issued after an enquiry has been opened. In practice, the opening of the enquiry and the issue of the notice may be simultaneous.

96. The notice will include the following details:

- the name of the person to whom it is issued
- the period to which it relates
- the transactions to which the notice applies
- HMRC's view of the implications of the notice for the taxpayer's liability to tax.

97. Once a notice has been issued, the taxpayer has 90 days to consider what effect the legislation has on its tax liability in the same way as it would

consider any other relevant tax legislation. Although HMRC will set out its view of the effect of the legislation in the notice, the taxpayer should base its self-assessment on its own opinion of its tax liabilities, in the same way as it must apply all other relevant tax legislation.

Clearances

98. HMRC will consider requests for advice about the legislation in sections 184G to H, including whether it will apply to a planned series of transactions that may constitute an arrangement, as detailed in Part 6.

99. It is important that any request for advice is made on the basis of full disclosure of all relevant facts, in order that any advice given may be relied upon.

100. HMRC will give advice concerning actual or proposed transactions. Where possible, we will confirm that no notice will be issued in respect of the disclosed transactions. If the information disclosed is insufficient to enable us to reach a decision, we will say so and if possible indicate what further information should be provided.

Part 6: Clearance Procedures

101. All clearance requests will be dealt with by the Anti Avoidance Group (Intelligence) Clearance and Counteraction Group. The unit will aim to work to a 30 day turnaround from receipt of the application provided all relevant information is included. If there is a particular need for a clearance to be given by a specific date applicants should specify this in their application. HMRC will do its best to accommodate these requests.

102. The information that the application should contain will depend to some extent on the nature and characteristics of each case although certain information will be required in all cases (see below).

103. Clearance applications and questions regarding the clearance procedure should be sent to:

HM Revenue & Customs
Clearance & Counteraction Team, Anti Avoidance Group
Intelligence
First floor
22 Kingsway
London
WC2B 6NR

Please mark the application "Capital losses clearance application".

Tel.: 020 7084 5525

Email: capitallosses.clearances@hmrc.gsi.gov.uk

104. A clearance will state the terms on which it has been given, provided the relevant underlying facts and legislation remain unchanged. HMRC will regard itself bound by a clearance as long as:

- All relevant facts are accurately given, and
- (where the clearance is given in advance of the execution of the relevant transaction or transactions) the transaction is executed in accordance with the proposals set out in the clearance application.

105. Where a clearance cannot be given HMRC will state the reasons. If a company disagrees with HMRC's view on a clearance it is entitled to make its self assessment on its own understanding of the law and how it applies to the facts given in the clearance application. Should a notice under this legislation subsequently be issued the company can appeal in the normal way against any amendment to the self-assessment which HMRC may make.

106. The application of the clearance may be reviewed by the company's local tax office to ensure that the facts and circumstances relating to the actual transaction are as described in the application.

107. The making of a clearance request does not affect any obligation to disclose the promotion or use of any arrangement under Part 7 Finance Act 2004.

108. HMRC would expect to receive the following basic information in a clearance application:

A. Details of scheme participants

1. *Company in which gain arises*

a. Name of company (and details of UK branch if overseas)

b. Name of ultimate UK parent (if member of a group)

c. Nature of the business of company

d. UK Tax office and reference number

e. Connection (if any) to other participants

2. *Company in which income deduction arises OR in which an income receipt would have arisen in the absence of the arrangement*

a. Name of company (and details of UK branch if overseas)

b. Name of ultimate UK parent (if member of a group)

c. Nature of the business of company

d. UK Tax office and reference number (where applicable)

e. Connection (if any) to company in which gain arises and other participants

3. *Other participants*

a. Name of each company (and details of UK branch if overseas)

b. Name of ultimate UK parent of each company (if member of a group)

c. Nature of the business of each company

d. Territory of residence of each company

e. UK Tax office and reference number of each company (where applicable)

f. Connection (if any) to other participants

B. Details of the scheme

1. Title, if any, of the arrangements

2. Summary of the proposal or arrangements

3. Explanation of each element in the arrangements from which the capital gain and the reduction of income profits arise

4. Statutory provisions relevant to those elements of the arrangements from which a tax advantage arises

5. Explanation of any commercial purpose for the arrangements

Part 7: Closed consultation

The draft guidance was first published on 5 December 2005 and was subject to a period of consultation to 5 February 2006.