

REFORM OF CORPORATION TAX

Schedular Reform

PARTIAL REGULATORY IMPACT ASSESSMENT

1. This RIA updates the partial RIA in the background notes (http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform-bg-notes-080803.pdf) that were published alongside the August 2003 Consultation Document *Corporation Tax Reform* (http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform.pdf). This RIA takes into account the many helpful responses that were received to that Consultation Document.

PURPOSE AND INTENDED EFFECT

OBJECTIVE

2. The Government is seeking the views of business on proposals, as part of the reform of corporation tax, to:
 - create a new 'operating business' category of income and expenditure which will encompass all trades, property letting and some activities currently within Case VI of Schedule D; and
 - abolish charges on income and instead treat such amounts as deductions in computing profits of an operating business.
3. The result of the changes would be that:
 - many companies should have greater flexibility to offset losses from one activity against profits from another, with their overall tax charge more closely reflecting their economic performance;
 - many companies should be able to reduce administrative costs by preparing one computation of profits/losses for all activities within the 'operating business'; and
 - administrative complexity should also be reduced following the abolition of charges on income, allowing companies to bring such items into their normal computation of profits.

BACKGROUND

4. The Government has received a number of representations, suggesting that the current system of taxing income under schedules (and cases within schedules) is outdated, distortionary and fails to reflect commercial

reality. The Corporation Tax Reform process has considered possible changes to the schedular system.

5. In the August 2003 Consultation Document *Corporation Tax Reform*, two options were aired - full pooling of all income sources and pooling of trading and letting sources. While most respondents favoured full pooling, others were of the view that there would be significant benefits, particularly for SMEs, in trading/letting pooling.
6. Corporation tax reform has not previously raised the prospect of the abolition of the charges regime but following legislative changes over the last decade, there is less justification for this separate category of expenditure to have its own specific tax treatment. The Government believes that could be replaced with a deduction in the new 'operating business' regime. This would further reduce legislative complexity and fits well with the rationalisation principles behind schedular reform.

RISKS

7. Our assessment is that this policy will deliver its objectives with relatively low risk of unforeseen consequences. A direct and intended effect of the proposed reform is that it will reduce financial risk for companies by increasing the opportunities for losses to be relieved against taxable profits. Currently companies may feel constrained from diversifying their activities where they are unable to set off taxable profits against tax losses.
8. The more flexible treatment of losses could have the potential to create additional opportunities for avoidance and manipulation of the rules and the Government will need to ensure that effective protection is put in place to protect the Exchequer.

OPTIONS

9. (A) The schedular system could be retained in its current form. The benefits would be that companies and their advisers would not have to incur additional expenses in familiarising themselves with the new 'operating business' rules, but the risks would be that some companies would have continue to have losses that could not be relieved against other profitable activities. In such circumstances groups might set up particular structures for tax rather than commercial purposes. Consultees have also advised that additional administrative costs are incurred as a result of the complexity of the schedular system. These costs may be proportionately higher where smaller groups and companies are involved.

If the charges regime is retained, as above, the benefit would be in not

having to adapt to the new legislation. The risk would be that a separate set of rules for giving relief for a diminishing set of types of payment would remain in place.

(B) Reform of the schedular system, by the creation of the new 'operating business' source, together with the abolition of charges, should reduce complexity and give greater scope for offsetting losses. All this fits with the modernisation agenda of the reform of corporation tax. The benefits are outlined below and as discussed above the risks arise from additional compliance costs in the transitional period and the risk to the Exchequer in respect of the more flexible treatment of losses.

(C) One further option, which was considered in the last consultation document was full pooling of all income and expenditure. The benefits of such an approach would be that companies would be fully able to set off a range of tax profits and losses, and it has been argued that taxing profits but not relieving losses may well provide a disincentive to pursue activities. However the risks inherent in this approach are significant in that effectively removing the current ring-fenced loss rules without restriction would increase the burden on profitable businesses to meet the resulting exchequer cost.

COSTS AND BENEFITS

BUSINESS SECTORS AFFECTED

10. These proposals would impact on single companies, groups of companies within the UK and multi-national enterprises. Companies across the spectrum of size and in all sectors could potentially benefit - whether they undertake more than one trade, a combination of trading and letting activities or pay charges.
11. There are specific proposals for the taxation of life insurance companies which will simplify complex tax legislation and allow greater set-off of losses. The proposals relate to the legislation which already governs the taxation of life insurance companies and the impact will therefore be on this sector.

ASSUMPTIONS

12. The Government has assumed in the preparation of its costings that companies and groups will choose to make any changes to the way that they calculate their taxable profits to benefit from these changes.

BENEFITS

13. There are both administrative and tax benefits for companies and groups as a result of these measures:

- tax computations should be easier to prepare as companies would not have to account separately for each trade and letting activity and charges. This will reduce companies' compliance costs;
- companies will have greater flexibility to offset losses. These changes will reduce the post-tax cost of capital and potential disincentives to invest.

ADMINISTRATIVE COSTS

14. Administrative resource will be required to alter the CT600 return form to reflect the new 'operating business' income source and these changes will also have to be mirrored in the online filing service. Administrative resource will also be required to rewrite guidance for customers and staff to reflect the new 'operating business' income source. New guidance would also necessitate some amount of retraining for staff involved in the handling of CT returns.

COSTS FOR A TYPICAL BUSINESS

15. There is some risk of additional compliance costs during the transitional period until companies familiarise themselves with the new regime. There may be initial tax/compliance costs where a group reorganises its activities to take account of the more flexible loss relief. However, this would only be where the resulting saving in tax costs is expected to outweigh the initial administrative costs. Otherwise, there should be no additional costs to businesses arising from this measure. As mentioned above, ongoing compliance costs should be reduced in many cases. But as part of the consultation process, it is intended that the views of business will be sought both on the potential upfront costs of coming to terms with the new legislation and the longer term cost benefits from the new 'operating business' source.

EQUITY AND FAIRNESS

16. Creation of the new operating business source and the abolition of charges would apply equally to all companies that satisfied the relevant criteria. This would include companies in all sectors and of all sizes.

SMALL FIRMS' IMPACT TEST

17. The criteria of the Small Firms' Impact Test were applied to this proposal. It is expected that the changes will reduce the administrative burden on small business. The underlying records that will need to be kept will be no different to those already maintained by small and medium sized businesses.
18. The point was made during the consultation process that merging trading and letting sources may well be most beneficial for small and medium-sized companies as trading and letting will commonly be their main sources of income - for which they will be able to prepare a single tax computation. The abolition of charges is unlikely to have particular effects either positive or adverse for small firms, when compared with large firms.
19. During each of the earlier consultation periods there was dialogue from the outset with the Small Business Service and representatives of small business. Small companies and their representatives were invited to, and did attend the consultation meetings. Small companies have expressed their satisfaction with the consultation process and contributed responses to the two earlier consultation documents.

COMPETITION ASSESSMENT

20. The competition filter test has been applied to these possible changes. The result of the test was that the changes are unlikely to have a significant detrimental effect on competition.
21. All markets will be affected by this possible change. The new regulations would not cost any one sector or size of companies more than others, though by definition, those companies that carry out trading and letting activities (or more than one trade) will benefit from the proposed new operating business source. These changes are not likely to affect the size of companies. The specific proposals for life insurance companies by definition affect a specific sector, but it is one which already has its own particular tax rules and the proposed changes should greatly simplify complex tax legislation, without adversely affecting competition in the life insurance sector.
22. The proposals have the potential to reduce ongoing administrative costs for companies and more closely align their tax profits and losses with economic profits and losses. Thus they will have a beneficial effect on all markets.
23. A detailed competition assessment is therefore not required.

DEVOLUTION

24. Corporation tax is a UK tax. The proposed changes will apply to all companies in the United Kingdom therefore there are no devolution impacts.

HUMAN RIGHTS/E-POLICY/ENVIRONMENT/RURAL-PROOFING

25. No expected adverse impacts.

SECURING COMPLIANCE

26. There are no changes to the existing enforcement provisions. The normal risk assessment by which a company's returns and accounts may be scrutinised will continue, to allow the Inland Revenue to check that the companies' self-assessments are correct. Guidance on the revised legislation for the Revenue and its customers will be issued as soon as possible after the legislation becomes law.

CONSULTATION

PUBLIC CONSULTATION

27. There was a series of consultation meetings following the publication of the 2002 and 2003 Consultation Documents, attended by more than 50 representatives of business. Additional meetings were held with those business sectors (including small business, retail, manufacturing, property, insurance companies, finance etc) with a special interest in these rules.

28. There were 155 written responses to the August 2002 Consultation Document and 148 to the August 2003 Consultation Document. Many of those that referred to the proposed reform of the schedular system and strongly supported the case for reform. All were broadly welcoming, although some expressed concern about limiting the proposed changes to trading and letting sources rather than all sources.

29. The Government has welcomed the comments that it has received from business during the periods of consultation. These have been used to develop the changes proposed in this technical note. Consultees were strongly in favour of schedular reform in principle, with some favouring full pooling of all sources and others seeing benefits in trading/letting pooling. The Government proposes to proceed with trading/letting pooling on the basis that this will still deliver significant benefits for many companies, with a more limited Exchequer cost.

WITHIN GOVERNMENT

30. The Department of Trade and Industry, Cabinet Office Regulatory Impact Unit, Small Business Service and HM Treasury have been involved in ongoing CT Reform consultation. There has also been wide consultation within the Inland Revenue including policy, operational and technical departments.

MONITORING AND REVIEW

31. Isolating the direct and behavioural impact of this proposal separately from that of other measures is likely to be difficult. As part of the consultation process the Inland Revenue will consider whether the potential compliance costs are reasonable in advance of the implementation of the policy.

SUMMARY AND RECOMMENDATION

32. It is intended that these measures will reduce both compliance costs and tax costs to business, and help to reduce distortions to investment decisions from tax. These factors will be fully explored as part of the consultation process in advance of public

CONTACT POINT

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