

**Tax Law Rewrite
Response to Paper
CC/SC (08) 03**

Relief for small companies

This document is available on the internet at:

<http://www.hmrc.gov.uk/rewrite>

11 July 2008

INTRODUCTION

1. We published Committee Paper CC/SC (08) 03 in January 2008 on the HMRC internet website www.hmrc.gov.uk/rewrite. The closing date for responses was 18 April 2008. The draft clauses rewrite the small companies' relief provisions in sections 13, 13ZA and 13A of ICTA.

2. The purpose of this response document is to provide details of the substantive points made and to explain our analysis and proposals in respect of them. Minor points such as suggestions to improve punctuation are not covered, but all comments received have been carefully considered.

3. We received written responses from the following:

- The Confederation of British Industry
- The Chartered Institute of Taxation
- The Institute of Chartered Accountants in England and Wales

4. We are very grateful for all the comments made, many of which were detailed and we appreciate the time and effort that went into them. We have sent each respondent a copy of this response document.

5. The following abbreviations for tax legislation are used:

- FA Finance Act
- ICTA the Income and Corporation Taxes Act 1988

General

The name of the relief is inaccurate because it is related, not to whether a company is small, but to the size of its profits. And the “marginal” relief is misleading because, in the range of profits to which it applies, the company’s profits are not “small”.

6. ***We propose to change the name of the main relief to “small profits rate” and to use “marginal relief” rather than “marginal small companies’ relief”.***

The opportunity is not being taken to codify the treatment that gives United Kingdom branches small companies’ relief. Why is this?

7. Section 788 of ICTA provides for “arrangements” (double taxation treaties) to be made with territories outside the United Kingdom for relief from tax. A common feature of such treaties is a “non-discrimination clause” which requires that a resident of the foreign territory should be treated no less favourably than a UK resident in similar circumstances.

8. One result of a non-discrimination clause is often that the profits of the United Kingdom permanent establishment of a non-UK resident company may be charged at the small companies’ rate of corporation tax. This is a double taxation rule, not one primarily about small companies’ relief. So we do not plan to include it in Bill 6.

9. ***We propose to mention this point only in the explanatory notes.***

Paragraph 5 of ESC C9 should be enacted as well as its other paragraphs.

10. Following the relaxations for partners in the rules about associated companies proposed in Finance Bill 2008, the simplification review of tax calculations for smaller companies may consider this part of the concession. While that review is going on we do not propose to enact this part of the concession.

11. ***We propose no further action.***

Clause 2: Profits charged at the small companies’ rate

Q1 We propose to drop the requirement for a claim for small companies’ relief.

12. This proposal was supported by the respondents who commented.

Will it be possible for a company to opt out of small companies’ relief?

13. It can sometimes cost more to prepare a claim for relief than the value of the relief. We accept that the removal of the need for a formal claim should not make the relief compulsory.

14. We considered a similar point in connection with trading deductions. In some cases the source legislation appeared to make a deduction mandatory but we consistently rewrote the rules to make them permissive (“a deduction is allowed”). In Exposure Draft No 10, published in March 2000, we said (in paragraphs 3.34 and 3.35):

We can think of no circumstances where there is an advantage to the taxpayer in not taking a deduction if by failing to do so the deduction is entirely lost. In particular, there are no penalties (other than an increased tax bill) for over-stating trading income in a return.

15. In practice HMRC do not regard a return as incorrect if it shows an amount of tax payable greater than the amount that would be due if every available deduction and relief is allowed. We will consider changing the guidance to make this clear.

16. ***We do not propose to provide a statutory “opt-out” for small companies’ relief.***

Clause 3: Marginal small companies’ relief

Q2 We propose to drop the requirement for a claim for marginal small companies’ relief.

17. This proposal was supported by the respondents who commented (subject to the point discussed in paragraphs 13 to 16 of this document).

The reference in subsection (2) to the “net profits” does not add anything.

18. In this clause we think that it is useful to emphasise the difference between “net profits” and “augmented profits”. But we will keep the point under review as our work on “total profits”, “net profits” etc develops.

19. ***We do not propose to amend the clause now to meet this point.***

The clause could be simplified by removing “the reference amount” from subsection (2).

20. We agree. By including the fraction in a slightly changed formula and not referring to a “reference amount”, the clause can be shortened by two subsections.

21. ***We propose to amend the clause to meet this point.***

Clause 6: Section 5(3): treatment of certain holding companies

Q3 We propose to enact SP5/94.

22. This proposal was supported by the respondents who commented.

If a company fails to meet one of the requirements in subsection (3) of the clause, there is an implication that it is treated as carrying on a business. This is a change in the law that is adverse to taxpayers.

23. It was intended that subsection (5) of the clause should put the matter beyond doubt. But we have reconsidered the structure of the clause. We propose to make clear at the outset that the clause applies only to companies that are carrying on a business of making investments. So it is clearer that the clause has no application to companies that do not carry on such a business. (Those companies do not need the benefit of the relief set out in this clause.)

24. ***We propose to amend the clause to meet this point.***

If a company receives a dividend (subsection (3)(c)) it cannot be true that it has no assets throughout the accounting period (subsection (3)(a)).

25. We agree. A new subsection will deal explicitly with assets held as the result of the receipt of a dividend and with the right to receive a dividend that is unpaid. Both sorts of assets will be excluded from those considered for subsection (3)(a).

26. ***We propose to amend the clause to meet this point.***

SP 5/94 refers to dividends received which are, or could be, franked investment income. The words “or could be” are not included in subsection (3)(c)(ii) of the clause. Do they have any significance?

27. Before 6 April 1999 SP5/94 referred to “dividends ... which are or could be the subject of a group election under section 247(1) of ICTA”. The words catered for the possibility that, although the income was of the right kind, no such election was made. The need to remove “or could be” when the SP was re-worded was overlooked and the words have no significance.

28. ***We do not propose to amend the clause.***

How is a company to meet the requirement in subsection (3)(e) if it meets such necessary costs as its audit and Companies House filing fees?

The condition relating to management expenses in subsection (3)(e) is confusing and misleading.

29. We agree. The point is not what expenses could be deducted *if* the company had investment business. The company must in fact be carrying on a trade or an investment business; otherwise it would not be within the scope of clause 5. And it may incur minor administrative expenses. The point is that the benefit of the practice is incompatible with a deduction for management expenses.

30. ***We propose to amend the clause to meet this point.***

Subsection (4) of the clause requires that the “passive holding company” pays out to its shareholders the amount of any dividend received in the same accounting period as that in which the dividend is received. SP 5/94 does not specify such a time limit. Is the more restrictive requirement intended?

Could the clause introduce a nine month limit for the payment of a dividend like that for a donation in section 339(7AA) of ICTA?

31. If the holding company is really “passive” there can be no need for it to retain the income received before distributing it to its shareholders. The essence of the arrangement is that the money should pass straight through the holding company. We think that the “in the accounting period” condition gives enough flexibility.

32. ***We do not propose to amend the clause to meet this point.***

Clause 7: Associated companies: fixed-rate preference shares

Q4 We propose to enact paragraph 2 of ESC C9.

33. This proposal was supported by the respondents who commented.

Clause 8: Association through a loan creditor

Q5 We propose to enact paragraph 3 of ESC C9.

34. This proposal was supported by the respondents who commented.

In paragraph 3 of ESC C9 the conditions that the loan creditor is not a close company and is a bona fide commercial loan creditor are expressed as alternatives.

The reference to section 417 of ICTA in subsection (4) of the clause does not go wide enough.

35. We were wrong to suggest that the exclusion for banks in section 417(9) of ICTA covers the same ground as the “bona fide commercial loan creditor” part of the statement of practice.

36. ***We propose to amend the clause to include the alternative condition relating to commercial loan creditors.***

Should not the conditions in subsection (1)(a) be split, like those in subsection (2)(a) and (b)?

37. ***We propose to adopt this suggestion.***

The definition of “connection” is ambiguous and circular. What is meant by “having dealings” with each other? The same point arises in connection with clause 9.

38. We do not agree that the definition (in subsection (5)) is ambiguous. It is drafted widely to include any sort of connection. In particular, it is intended to cover the example given by the respondent of neighbouring companies who become engaged in a property dispute.

39. ***We propose to retain “dealings” so that the rule applies as widely as possible but propose to change the definition of “connection” to remove the circularity.***

Clause 10: Meaning of “augmented profits” in this Chapter

We should move away from the term “franked investment income”.

40. The abolition of advance corporation tax by section 31 of FA 1998 means that the quoted expression is used in fewer contexts than previously. But it is still a useful expression to describe a qualifying distribution with any associated tax credit, while excluding non-qualifying distributions.

41. ***We do not propose to amend the clause to meet this point.***

The conditions in subsection (3)(b) could be split.

42. ***We propose to adopt this suggestion.***

Clause 11: Interpretation of section 10(2) and (3)

Subsections (1) and (2) should be merged.

43. We think that this suggestion would involve a change of perspective that would disturb the way subsection (3) works. It is important that the application of section 838(1)(a) of ICTA is free-standing.

44. ***We do not propose to adopt this suggestion.***

The tests in subsection (5) should be aligned.

45. ***We propose to adopt this suggestion.***

Clause 12: Close investment-holding companies

It is misleading to apply the test at the end of an accounting period when the conditions have to be met throughout the period.

46. We agree (although the draft clause follows the source legislation). We propose to identify the test in clauses 2(b) and 3(1)(b) as one applying “in” the accounting period (instead of “at the end of” the period). The test itself will be defined in this clause by reference to the purposes of the company throughout the period.

47. ***We propose to amend the clauses to meet this point.***

In subsection (2), dropping the word “purpose” or “purposes” from the beginning of each permitted purpose and the insertion of “the carrying on of” obscures the meaning of the rules.

48. ***We propose to reinstate the reference to purposes in each paragraph of subsection (2).***

The condition in subsection (3) would be clearer if expressed positively.

49. ***We propose to adopt this suggestion.***