Tax Law Rewrite – Bill 5

Responses to Papers CC/SC (08) 25, 26 and 27

Relationships treated as loan relationships etc: OEICs, unit trusts and offshore funds

Intellectual property: know-how and patents

Loan relationships, derivative contracts and intangible fixed assets: provisions affected by the European Mergers Directive

This document is available on the internet at:

http://www.hmrc.gov.uk/rewrite 24 October 2008

Bill 5 response document
Committee papers CC/SC (08) 25, 26 and 27

INTRODUCTION

1. In June 2008 we published Committee Papers CC/SC (08) 25, 26 and 27 on the HMRC internet website www.hmrc.gov.uk/rewrite. The closing date for responses was 19 September 2008. The draft clauses rewrite the legislation for:

- Relationships treated as loan relationships etc: OEICs, unit trusts and offshore funds
- Intellectual property: know-how and patents
- Loan relationships, derivative contracts and intangible fixed assets: provisions affected by the European Mergers Directive.

2. The purpose of this response document is to provide details of the substantive technical 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. Some respondents made useful suggestions about the explanatory notes. We have not commented on these in every case but we will revisit the explanatory notes with them in mind.

3. Some respondents made policy suggestions for reform. Such issues are outside the remit of the Tax Law Rewrite project but we have passed them to the relevant specialists for consideration.

4. Some minor changes were proposed in the Committee Papers. Where no mention is made of these in this response document, they either received approval or were not mentioned in responses.

5. We received written responses from the following:

- The Institute of Chartered Accountants in England and Wales
- The Confederation of British Industry
- Two individuals.

6. The following abbreviations for tax legislation are used in this response document:

- CAA Capital Allowances Act 2001
- FA Finance Act
- ICTA Income and Corporation Taxes Act 1988

- TCGA Taxation of Chargeable Gains Act 1992
- ITA Income Tax Act 2007
- ITTOIA Income Tax (Trading and Other Income) Act 2005.

7. We are 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.

Relationships treated as loan relationships etc: OEICs, unit trusts and offshore funds

Clause 7: The qualifying investments test

> *I would suggest that the rewrite of the provisions covered by Paper (08) 25 would be improved if the concept of "qualifying investments" were to be replaced by something which is more intuitive and more user-friendly.*
>
> *It seems to me fair to say that, in a normal use of language, "qualifying" is a word that has a positive connotation. However, in the context of these provisions "qualifying investments" are in fact investments that a shareholder or unit holder would probably wish an OEIC, unit trust or offshore fund not to have.*
>
> *I accept, of course, that the concept was used in FA 1996 Schedule 10. It is also a step forward to get away from the "double negative" in the source legislation of failing to satisfy the non-qualifying investments test.*
>
> *However, there must be a better label than "qualifying investments". I would suggest that "financial investments" would be a definite improvement.*

8. Although we accept the point raised, the term "qualifying investments" is currently used in Regulation 20 of the Authorised Investment Funds (Tax) Regulations 2006 (SI 2006/964) with a very similar meaning (although not quite identical due to the context of Authorised Investment Funds rather than funds in general). Therefore it would probably be more confusing to have a different term where the meanings are very similar.

9. ***We will not amend the clause to meet this point.***

Clause 8: Meaning of "qualifying investments"

> *Clause 8(2) I found it slightly confusing having a definition of "derivative contract" and also a reference in the definition of "contract for differences" to a derivative contract.*

10. The definition of "contract for differences" brings into this Part the meaning given to that term in the Part dealing with derivative contracts. In the definition of "contract for differences" the words "derivative contracts" only occur in the bracketed words giving the title of that Part. They are not operative.

11. Although no change results from the response, when examining this clause again, we concluded that it is not necessary to include the definition of "derivative contract". If a contract is treated as a derivative contract in the Part dealing with derivative contracts then it will also be treated as a derivative contract for the purposes of this clause, because the definition of "derivative contract" in section 834(1) of ICTA (which currently refers to Schedule 26 to FA 2002 and is

being amended to refer to the Part dealing with derivative contracts) applies for the purposes of the Corporation Tax Acts.

12. ***We will amend this clause.***

Intellectual property: know-how and patents

Clause 1: Overview of Part

> *The provisions rewritten in this Part are provisions which, particularly as time passes, are of less and less importance. It would be very helpful if the limited circumstances in which they apply were made explicit at the beginning of the first clause.*

13. We agree that in one sense the provisions rewritten in this Part of the Bill are the "old" provisions to the extent that (broadly) for assets acquired or created after 1 April 2002 the provisions of Schedule 29 to FA 2002 (rewritten in a separate Part) will exclusively govern their tax treatment.

14. However the "old" provisions will (again broadly) continue to apply, potentially indefinitely, to assets not falling within the new regime and it would be misleading to do anything which might suggest otherwise.

15. Subsections (4) and (5) of the clause warn readers of the primacy of the new regime and paragraph 7 of the Explanatory Notes to this clause emphasises that fact. We think that is all that is needed.

16. ***We will not amend the clause to meet this point.***

Clause 6: Charge to tax on profits from sale of patent rights

> *This clause appears to be saying that profits from sale of a UK patent by a non-resident company are in all cases subject to corporation tax. In other words it appears to be stating an exception, such as is mentioned in clause 6(4) of the draft Bill, to the general rule on territoriality. It should be made clear that it is subject to clause 6(2) and (3) of the Bill. It is very noticeable that clauses 10(5) and 11(5) reproduce the territoriality rule in the form which appears in the source legislation (section 524(6) echoing section 524(5) in that respect), whereas this basic charging clause does not.*

17. We believe this clause does not set up an exception to the normal territoriality rules, particularly when read with the clause which immediately follows it. We do not think there is any inconsistency with clauses 10(5) and 11(5) because those provisions are not intended to clarify the application of the territoriality rule. Rather, when a company elects to spread, for tax purposes, the receipt of its proceeds of sale, the provisions impose a condition for the continuing effect of the election.

18. ***We will not amend the clause to meet this point.***

Clause 7: Profits charged under this section

> *It seems strange that whereas subsection (2) gives a deduction for expenses of sale subsection (4) gives no deduction for incidental purchase costs.*

19. These corporation tax clauses reflect the same approach to rewriting the source legislation as did their ITTOIA counterparts. The ITTOIA equivalent of clause 7 is section 588. The Explanatory Notes to section 588 of ITTOIA (and to clause 7 of the draft) explain that the rewritten provision makes explicit what is merely implicit in the source: that any incidental expenses of the sale are deductible. We do not think that the corporation tax rewrite of the source legislation should go any further.

20. ***We will not amend the clause to meet this point.***

Clause 8 - UK resident companies: spreading rules

> *If there is no change in accounting date, an accounting period will begin on the sixth anniversary of the beginning of the period of receipt. Subsection (2)(b) is ambiguous as to whether the charge applies in this period. ... The problem arises at least in part from the use of the word "anniversary", which suggests a particular day (i.e. if the period of receipt begins on 1 January 2010 the sixth anniversary is 1 January 2016), when what is meant is actually the instant in time with which that day begins.*

21. We do not perceive any ambiguity in this clause. "Until" in context seems to us to exclude any periods which *begin* on the sixth anniversary.

22. However, we will substitute for the reference to "anniversary" a form of words to make it absolutely clear that the 6-year period ends at a precise moment in time.

23. ***We will amend the clause to meet this point.***

Clause 9: UK resident companies: spreading where proceeds of sale received in instalments

> *Clauses 9 and 10 rewrite what is dealt with in one clause in ITTOIA. There is insufficient justification for the duplication involved in using a separate clause, and as a more general principle it is desirable that income tax and corporation tax rules should as far as possible follow the same pattern if there is no difference in substance between them.*

24. We believe that the separation of the material here makes the clauses clearer and that, on balance, the small deviation from the ITTOIA approach is worthwhile. It is also consistent with the approach in clause 11 mentioned below.

25. ***We will not amend the clause to meet this point.***

26. The same matter in respect of clause 8 also arose for clause 9.

27. ***We will amend the clause to meet that point.***

Clause 10: Non-UK resident companies: election for spreading

“Anniversary” creates an ambiguity in subsection (3): if the period of receipt begins on 1 January 2010, is an accounting period ending on 1 January 2016 included in the spreading period?

28. We agree that there is ambiguity here.

29. ***We will amend the clause to meet this point.***

Explanatory Notes on how subsection (5) of each clause works in practice would be helpful.

30. ***We will add something on this to the Explanatory Notes.***

Clause 11: Non-UK resident companies: spreading where proceeds of sale received in instalments

As in clause 9 the use of a separate clause seems unnecessary, but in this case since ITTOIA follows the same pattern it is probably best to maintain consistency.

31. We think the ITTOIA approach is clear and agree that it should be followed.

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

33. The same matters in respect of clause 10 also arose for clause 11.

34. ***We will amend the clause and Explanatory Notes to meet those points.***

Clause 12: Winding up of a body corporate

It is not clear why the words in brackets appear in subsection (2)(b). This appears to be an inappropriate transposition from the corresponding income tax rule.

35. We agree.

36. ***We will amend the clause to meet this point.***

Clause 14: Adjustments where tax has been deducted

The clause is not quite right in its reference to a sum that has been deducted “by virtue of” clause 13(2). The deduction is by virtue of section 910 of ITA and clause 13(2) does not, of itself, allow or require any deduction but simply clarifies the inter-relationship between provisions being rewritten here and section 910 of ITA.

37. We agree.

38. ***We will amend the clause to meet this point.***

Clause 17: Sums paid for Crown use etc treated as paid under licence

The commentary says that the words "used" and "use" are intended to be read widely so as to cover "make" and "sell". Any such "reading" goes far beyond the natural meaning of the words and it is not satisfactory, above all in a Rewrite Act, that words should be used with the intention that they take an artificial meaning which can only be ascertained by reference to the explanatory notes. We agree that the wording of this clause should correspond to that in section 482 CAA, but what really seems to be hinted at here is a drafting error in section 482 (which uses the same wording but does not have a corresponding explanatory note).

39. The wording here reflects parallel legislation in CAA and ITTOIA and the established interpretation of that legislation. Equally the Explanatory Note to this clause reflects the Explanatory Note to the parallel ITTOIA provision. A different text would be unhelpful and potentially misleading if it appeared to suggest a divergence of interpretation.

40. ***We will not amend the clause or the Explanatory Note to meet this point.***

Schedule 2: Repeals

The repeal of the whole of paragraphs 202 and 207 of Schedule 1 to ITTOIA includes amendments to provisions of ICTA not rewritten in the Paper CC/SC (O8) 26 draft clauses.

41. ***These repeals anticipate the position for the whole of Bill 5 in respect of these paragraphs and are not limited to the intellectual property clauses. We apologise if this gave rise to confusion.***

Loan relationships, derivative contracts and intangible fixed assets: provisions affected by the European Mergers Directive.

Appendix A (Loan relationships)

Clause 5: Group transfers and transfers of insurance business: transfer of loan relationship at notional carrying value

The heading of clause 5 does not bring out its real purpose of dealing with cross-border reorganisations.

42. ***We agree and the heading will be changed to reflect this.***

Clause 9: Receiving company using fair value accounting

Clause 9(2) has split a single proposition in the source legislation into separate paragraphs. This is unsatisfactory as one appears to be required to use one of two different values and the same rule is also expressed differently in for example clause 15(2). Clauses 9, 17 and 28 are also affected.

43. ***We agree and the two paragraphs will become one.***

Paragraph 12G of Schedule 9 to FA 1996 has not been rewritten to the extent that it also covers transactions which fall within paragraphs 12C and 12E(2).

44. Paragraph 12G of Schedule 9 to FA 1996 treats original shares which represent a loan relationship as being disposed of at notional carrying value or fair value where the company in which the shares are held undergoes a reorganisation of share capital which falls within sections 127 to 130 of TCGA and certain conditions are met. One of these conditions is that paragraphs 12B, 12C, 12D(2) and 12E(2) of Schedule 9 to FA 1996 apply in relation to the reorganisation. Paragraphs 12C and 12E of Schedule 9 to FA 1996 deal with double taxation consequences of cross-border transfers and mergers. Paragraphs 12C and 12E are now rewritten as sections to be inserted into ICTA.

45. ***The rewrite of paragraph 12G of Schedule 9 now incorporates the conditions that paragraphs 12C and 12E(2) apply in relation to the reorganisation.***

SI 2007/3186 inserted paragraphs 12H(3)-(5) and (as amended by SI 2008/1579) 12I (3)-(5) into Schedule 9 to FA 1996 (Loan relationships: special computational provisions). Are these provisions to be rewritten in Bill 5, or elsewhere?

The same query arises as regards paragraphs 30G(3)-(5) and 30H(3)-(5) of Schedule 26 to FA 2002 inserted by SI 2007/3186, relating to derivative contracts, and as regards inserted paragraphs 85B(3)-(5) and 85C(3)-(5) of Schedule 29 FA 2002 inserted by SI 2007/3186 (as amended by SI 2008/1579) and relating to intangible fixed assets.

All of these provisions relate to transparent entities.

46. Again, these provisions all relate to double taxation relief and will be rewritten as inserted section 807F in Part 18 of ICTA.

47. ***Paragraphs 12H(3)-(5) and 12I(3)-(5) of Schedule 9 to FA 1996 (and equivalent provisions) will be rewritten as amendments of Part 18 of ICTA.***

Clause 21: Disapplication of Chapter where transparent entities involved

Clause 21 does not appear to reproduce the effect of the words in brackets in paragraph 12H(1)(a) of Schedule 9 to FA 1996.

48. Paragraph 12H of Schedule 9 to FA 1996 both disapplies paragraphs 12D and 12G of the Schedule where the transferor is a transparent entity and also deals with double taxation consequences of cross-border transfers. Paragraph 12H is only rewritten in Part 5 (loan relationships) to the extent that it disapplies paragraphs 12D and 12G. To the extent that paragraph 12H deals with double taxation matters it is rewritten in new section 807F to be inserted into ICTA. The bracketed words in sub-paragraph (1) apply to double taxation matters in the paragraph.

49. ***The bracketed words are rewritten in new section 807F of ICTA.***

Appendix B (Derivative contracts)

Clause 2 - Transfer of derivative contract at notional carrying value

Sub-clause (1) applies this clause where the transferor "transfers rights and liabilities under a derivative contract". The source legislation applies where the transferor transfers the rights and liabilities under the contract. The meaning is not the same, since the version in the source legislation would apply only if all the rights and liabilities under any particular contract are transferred. It can also be rather more easily understood as covering the (possibly theoretical) case where the transferor has only rights, or only liabilities, to transfer.

50. ***We agree and will amend the clause.***

Clauses 4 and 11: Tax avoidance etc

Perhaps it's the effect of all the bracketed references, but clauses 4(3) and 11(3) are hardly straightforward, rewrite style drafting.

51. We agree that provision of the clearance procedure by reference to an earlier Part of the Bill may be difficult to follow. We will reduce the number of cross references and bring cross referencing in the second Chapter closer to home.

52. ***We will drop the first of these subsections and add clauses in the Chapter for European cross-border transfers of business that set out the clearance procedure in full on the model of the loan relationships equivalent clauses (clauses 19 and 20 in Appendix A). The Chapter on European cross-border mergers will refer instead to the added clauses.***

Clauses 5 and 12: Disapplication of Chapter where transparent entities involved

Given that there is a definition of "company" in clause 6(1) as any entity listed as a company in the Annex to the Mergers Directive, why doesn't clause 5(2) read: In this section "transparent entity" means a company which is resident in a member State other than the United Kingdom but which does not have an ordinary share capital? The same point arises in clause 12(3) and in clause 5(4) in Appendix C.

53. We agree there is a degree of overlap between clause 5(2) and the definition role of clause 6(1), and in the equivalent clauses in Appendices A and C.

54. ***We will amend the clauses to eliminate the overlap.***

Clause 5: Disapplication of Chapter where transparent entities involved

The same point arises as in clause 21 of the draft legislation on loan relationships, above.

55. ***See the comments in paragraph 48 which apply equally in relation to paragraph 30G(1) of Schedule 26 to FA 2002.***

Paragraph 30B of Schedule 26 to FA 2002 was substituted by new paragraphs 30B and 30C (the latter of Schedule 26 to FA 2002 is not rewritten in Paper CC/SC (08) 27). What is intended as regards rewriting new paragraph 30C?

56. Paragraph 30C of Schedule 26 to FA 2002 makes provision for double taxation relief. The same applies to paragraph 12C of Schedule 9 to FA 1996. These provisions will be rewritten as inserted sections 807D and 807E in Part 18 of ICTA. We apologise for not making this clear.

57. ***Paragraph 30C of Schedule 26 to FA 2002 (and equivalent provisions) will be rewritten as amendments of Part 18 of ICTA.***

Clause 7: European cross-border mergers: introduction to Chapter

Clause 7(6)(b) of Appendix B. Are the words 'to any person mentioned in that paragraph' necessary? They are not included in the similar Appendix A clause 23.

58. We agree the words are superfluous.

59. ***We will amend the clause.***

Appendix C (Intangible Fixed Assets)

Where are paragraphs 87 (as amended by SI 2007/3186) and 87A (as amended by SI 2007/3186 and SI 2008/1579) of Schedule 29 to FA 2002 to be rewritten?

60. ***Again, these paragraphs will be rewritten as amendments of Part 18 of ICTA. We apologise for not making this clear (see also paragraphs 46 and 47).***

Clause 1: Certain transferees of businesses etc not treated as leaving group

In subsection (1)(b), which is the "transfer"- the transfer of the relevant asset or the transfer to which section 5 etc applies?

61. The transfer in question is the transfer to which section 5 etc applies.

62. ***We will not amend the clause to meet this point.***

In subsection (1)(b), why would the transferee cease to be a member of a group "as a result of the transfer"- surely it must be some other aspect of the transaction that causes that?

63. The consideration for the transfer has to be given in the form of securities which can lead to a change of ownership of the company and hence degrouping (see clause 4).

64. ***We will not amend the clause to meet this point.***

Clause 5: Transfer of assets on European cross-border transfer of business

The same point arises as in clause 21 of the draft legislation on loan relationships, above.

65. ***See again the comments in paragraph 48 which apply equally in relation to paragraph 85B(1) of Schedule 29 to FA 2002.***

"Trade" should be "business" in sub-section (2).

66. We agree.

67. ***We will amend the clause to meet this point.***

Clause 6: European cross-border mergers: introduction

In subsection (2) where is the definition of "SE" and "SCE"?

68. The definition of "SE" will be included in an "Other Definitions" clause in Part 21 of the Bill and will also appear in the Index of expressions in Schedule 4 to the Bill. We apologise that we did not explain this. "SCE" is not defined at the moment but we agree that such a definition would be helpful.

69. ***We will insert definitions of "SE" and "SCE" in an "Other Definitions" clause in Part 21 of the Bill and they will also appear in the Index of expressions in Schedule 4 to the Bill.***