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## REGULATORY IMPACT ASSESSMENT FOR CORPORATION TAX - EXTENSION OF GROUP RELIEF

### Purpose and Intended Effect of the Measure

#### *The Policy Objectives*

**6.1** This regulatory impact assessment considers the effect of changes to the group relief legislation for companies. These changes are being made in order to clarify the UK legislation following the decision of the European Court of Justice (“ECJ”) in *Marks and Spencer plc v David Halsey* (C-446/03).

**6.2** The proposed changes will, in some limited circumstances, allow a UK company to claim tax relief for otherwise unrelievable losses incurred in the European Economic Area (‘EEA’). The changes will be tightly targeted to ensure relief is only given in these circumstances and will not, for example, allow groups to engineer their circumstances to obtain a tax advantage.

**6.3** This measure will make clear for companies the UK’s interpretation of the decision of the ECJ.

#### *Background*

**6.4** The group loss relief rules are designed to give businesses the ability, as far as possible, to structure their activities in the way that best suits their commercial drivers and to recognise the fact that a group of companies is an economic unit.

**6.5** On 13 December 2005 the ECJ handed down its decision in the *Marks & Spencer* case. This case concerned the UK’s tax loss relief rules for groups of companies and whether the UK’s rules, in precluding relief for the losses of subsidiary companies established in other Member States of the European Union, constitute a restriction on freedom of establishment under articles 43 and 48 of the EC Treaty.

**6.6** The ECJ ruled that these restrictions in the UK’s group relief legislation were, in principle, compatible with Community law, but went too far in denying loss relief to a parent company for the losses of a subsidiary where those losses are unrelievable in its Member State of residence. The changes to group relief proposed by the Government will amend the law to allow relief for unrelievable losses in the circumstances described by the ECJ.

#### *Why these changes are needed*

**6.7** Following the ECJ’s judgment in *Marks & Spencer*, the existing UK legislation must be interpreted in accordance with that judgment. The Government is therefore making those changes it considers necessary in order that the UK legislation reflects Community law as clarified by the ECJ’s decision.

#### *Consultation*

**6.8** HM Treasury (HMT) has worked closely with HM Revenue and Customs (HMRC) in order to ensure that the necessary changes can be made and effectively put into practice.

**6.9** In the short interval between the judgment and Budget 2006, there has not been time to consult formally with business on the operation of the new rules. Moreover, any consultation would necessarily (a) have been limited in its scope, given the narrow terms of the ECJ's decision and (b) have delayed the achievement of greater certainty following that decision. Nevertheless, HMT and HMRC are interested in hearing comments from business on how best the limited extension of relief can be operated with minimal cost for the small number of claimants that may be affected.

## **Options**

**6.10** The Government considered four options in response to the Marks & Spencer decision.

### ***1. Do Nothing***

**6.11** The effect of the ECJ's judgment in Marks & Spencer is that UK legislation has to be interpreted in the light of that decision clarifying Community law. This does not necessarily require a change to UK tax legislation, particularly as the circumstances where relief is given in the UK will be exceptional.

**6.12** However, this approach would be very difficult to apply in practice as neither business nor tax administrators would have a clear idea of what the rules were, or the extent to which the principles of the judgment would be applied to circumstances wider than the narrow scope of the judgment.

**6.13** As a result this could significantly increase compliance costs for business and administrative costs for HMRC. Also, some rules, particularly tax avoidance rules, require explicit legislation. By not legislating, the Government could risk substantial Exchequer losses through tax avoidance.

### ***2. Legislate in 2007***

**6.14** This option would have allowed more time to engage with business regarding the operation of the changes needed to UK tax law to reflect the ECJ's decision in that law. However, it would also have meant continuing to work without clear legislation for another year raising compliance costs for both business and Government. It would also risk substantial Exchequer losses through tax avoidance in this period.

### ***3. Legislate in 2006***

**6.15** This is the option chosen by the Government. It gives clarity for business and tax administrators through explicit rules and enables the Government to protect the Exchequer from undue loss through tax avoidance. Business can comment on the practical operation of the rules from a clear understanding of how the Government is interpreting the decision and what those rules are.

### ***4. Abolish Group Relief***

**6.16** In supporting the Government's case before the ECJ some other Member States pointed out that an adverse decision could have damaged business in the European Union by making group relief, and equivalent systems in other countries, too costly to sustain. In its judgment, the ECJ clearly understood the weight of this argument, and also noted the inappropriateness of a loss being relieved in more than one country. And

it decided that relief for losses of companies outside the UK tax net need only be given in very restricted circumstances.

**6.17** Since the terms of the judgment mean group relief should only be extended in very narrow circumstances, the cost to the Exchequer of that extension will be relatively small. This cost is estimated at £50m a year. The Government considers that this cost is sustainable and therefore did not need to consider the option of abolition further.

### **Business Sectors Affected**

**6.18** This measure will in general affect larger businesses that organise their activities in groups of companies operating in more than one country.

### **Other impacts**

**6.19** All options have been assessed in terms of equality, sustainability, the environment, and directly attributable social costs or benefits and there are considered to be no significant impacts.

### **Benefits**

**6.20** The principle benefit to business from the extension of loss relief is to reduce the risks for UK companies carrying out business in other parts of the EEA by providing tax relief for certain losses where there is no possibility of relief elsewhere.

**6.21** By choosing the option of bespoke legislation now the Government will give business certainty. In turn this should reduce the cost to business of tax advice on how the group loss rules will be applied.

### **Costs**

#### ***Exchequer Cost***

**6.22** The predicted Exchequer cost of these changes is an annual cost of £50 million.

#### ***Costs to business - Compliance***

**6.23** The extension of the group relief rules is a benefit to business, but there will inevitably be some new costs, mainly in tax, legal and accountancy advice, for those companies that are able to claim relief under this measure. However the claims procedure has been kept as similar as possible to the existing procedure so as to reduce additional costs.

**6.24** Where changes have been necessary is in relation to enquiries. These changes are needed because the unrelievable losses which are a necessary requirement before relief can be claimed in the UK are foreign losses which are not part of, or quantified under, the UK tax system. Further, the company that incurs these losses is also not subject to the UK's tax rules.

**6.25** To overcome these problems, it is the UK based claimant companies that will potentially have to prove that any loss is unrelievable and that it has been correctly computed. An enquiry will therefore potentially involve a claimant company providing information about the surrendering company and any intermediary company where the loss has been declared wholly or partially unrelievable.

**6.26** This is an essential part of the compliance regime to ensure that the relief is properly targeted and not abused. The Government is seeking to reduce uncertainty and any related costs through legislation and detailed guidance.

### **Public Sector Costs and Benefits**

**6.27** There will be minor additional costs for HMRC as a result of this measure in relation to a change to the company tax return and associated online services. Enquiries will be opened using HMRC's standard risk-based approach.

### **Small Business Impacts**

**6.28** Although group relief is open to all business, the international scope of the changes suggests that the measure is unlikely to have much impact on small businesses.

### **Unintended Consequences**

**6.29** There are not expected to be any unintended consequences arising from this tax legislation. The Government will include provisions to ensure that companies cannot contrive their circumstances so as to obtain relief in the UK. The Government announced its intention to introduce these provisions on 20 February 2006. Those provisions will be effective from that date.

### **Competition Assessment**

**6.30** The change to the group relief rules will affect all markets equally because the rules are not restricted to any particular business sector. These tax provisions will impose additional compliance costs for those UK resident companies making a claim. Despite this, overall it is to be expected that such companies would gain since they are unlikely to claim unless these additional costs are outweighed by the reduction in corporation tax.

**6.31** It is anticipated that the legislation will not affect competition materially. It is possible, however, that the legislation will have some effect on the market structure relating to cross-border investment. This is because the new tax legislation will reduce the effective tax rate slightly and hence the difference between pre- and post-tax profits.

**6.32** Firstly, there may be an increase in cross-border investment into the EEA since the new tax relief could affect investment decisions at the margin. A second effect may be that some companies choose to establish European subsidiaries rather than trading through branches of UK companies. However, these effects will be limited because relief for foreign losses will only be available in very restricted circumstances – the expected cost is just £50mn a year which compares to UK foreign direct investment into the EEA of £350bn (Office of National Statistics – 2004).

**6.33** The tax relief will not restrict the ability of companies to choose the price, quality, range or location of their products. However, the decision regarding the location of production may be affected since the new legislation will make outward foreign direct investment in the EEA more attractive than investment in non-EEA countries. Given that taxation is only one of a number of factors in influencing decisions on where to establish a new business, and the very restricted circumstances where relief for foreign losses will be available, this effect is also likely to be minimal.

## Securing Compliance

**6.34** This measure introduces a novel problem in that it enables a UK corporate taxpayer to claim relief for tax losses incurred by a company that is not subject to UK taxation or tax rules. In order to prevent unnecessary complexity and difficulty in applying this measure the responsibility for compliance in both demonstrating that a loss is unrelievable, and in computing the measure of that loss for the purpose of corporation tax relief will lie entirely with the UK claimant company. This will avoid the necessity of introducing a new compliance regime for taxpayers not currently subject to taxation in the UK, and the Government is satisfied that this is proportionate.

## Implementation and Delivery Plan

**6.35** For a company to claim relief for losses that are unrelievable elsewhere in the EEA it will have to fill in the company tax return as usual. The only change is that it will have to tick a new box indicating that it is making one of these claims. However the company will need to be sure that the foreign loss has been correctly computed and is unrelievable in the foreign country or countries concerned. For this it may need detailed information from the surrendering company and any intermediary companies. If HMRC chooses to open an enquiry, the claimant company may be required to produce any of this information. The standard penalties and appeal process will apply.

**6.36** HMRC will continue to provide the necessary education, guidance and support to operational staff who will be processing these claims and enquiries.

## Monitoring and Evaluation

**6.37** An extra box will be inserted onto the company tax return (CT600C) form. This will enable HMRC to identify all claims relating to this measure. The Government will therefore be able to monitor any claims and see whether this measure is correctly targeted. In due course HMRC will also undertake a review of the requirements placed on companies in Standard Cost Methodology terms.

## Summary and Recommendation

**6.38** This measure will:

- mitigate some of the risks arising from commercial failure for UK companies doing business through EEA subsidiaries, and
- ensure that the UK's group relief rules comply with Community law as it currently stands.

**6.39** By introducing legislation in the 2006 Finance Bill the Government is taking the earliest opportunity to give the necessary clarity to business.

**Contact Point**

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**REGULATORY IMPACT ASSESSMENT****Corporation Tax – Extension of Group Relief****Statement of Ministerial Approval**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 8 March 2006