

REGULATORY IMPACT ASSESSMENT FOR EXEMPTIONS FOR GAINS AND LOSSES ON SUBSTANTIAL SHAREHOLDINGS

Introduction

1. This Regulatory Impact Assessment sets out the costs and benefits of the exemption regime for gains and losses on disposals of substantial shareholdings to be introduced in Finance Act 2002.

Purpose and Intended Effect of the Measure

2. At present, when groups of companies wish to restructure for commercial reasons to take advantage of emerging global opportunities in a rapidly changing world, they may face large tax charges on any resulting capital gains. This can lead to essential business decisions on restructuring and reinvestments being influenced by the tax system. It can also encourage many multinational groups to put in place complex offshore holding structures that add unnecessary administrative burdens. The exemption regime being introduced will provide business with greater flexibility in these areas.

3. This measure forms part of the Government's programme to create a modern, competitive and fair corporate tax regime that will provide stability for business in the longer term. The new relief will put the UK in a similar position to other countries that already operate exemption systems.

Risks

4. Without this relief the ability of UK-based groups to restructure in response to emerging global business opportunities could be constrained by the tax system. A perception that the UK corporate tax system could lead to tax considerations rather than commercial factors driving business decision-making in this area could be damaging to the attractions of the UK as a place from which to conduct international business.

5. Although tax is only one of many factors taken into account when multinational enterprises decide where to locate global and regional headquarters activity, it is important that the UK tax system should keep pace with changes in the global business environment. Failure to do so could mean that we might not retain significant levels of headquarters activity in the UK. There is evidence that headquarters activity brings with it a number of economic advantages, for example in terms of the provision of business services, which might be lost to the UK economy if headquarters were to move elsewhere.

Options

No change

6. One option was to make no change to the law. This would have perpetuated the risks and administrative burdens described above.

A deferral regime

7. Before putting forward proposals for exemption, the Government had consulted on the possibility of a deferral regime. Under the proposed regime, gains on disposals of qualifying shareholdings would have been deferred if the sale proceeds were to have been invested in qualifying assets. One feature of deferral when compared to exemption is that it would apply only to gains and leave losses allowable. However, early discussions with companies indicated that the tracking requirements associated with deferral would add to compliance costs and all indicated a preference for exemption.

An exemption regime

8. The main provisions can be summarised as follows. When a trading company or a member of a trading group disposes of shares in a trading company or the holding company of a trading group any gain arising on the disposal will be exempt, and any loss disregarded, for corporation tax purposes, where the investing company meets the substantial shareholding requirement. The requirement is that the investing company must have:

- owned at least 10% of the ordinary share capital of company invested in throughout a continuous period of twelve months during the two years before the disposal;
- been beneficially entitled during that twelve month period to at least 10% of that company's distributable profits and assets distributable on a winding up.

For the purposes of deciding whether the 10% requirements are met, the holdings and entitlements in the company invested in which are owned by members of the same group as the investing company are aggregated.

9. Respondents to the 19 July 2001 consultation document, which provided details of possible deferral and exemption regimes, were unanimous in their preference for exemption.

Benefits

10. The direct benefit of exemption will be to trading companies or members of trading groups making gains on disposals of substantial shareholdings.

11. UK-based trading groups, no longer faced with a charge on gains on substantial shareholdings, will be able to restructure more easily to respond to emerging global marketing opportunities. The new regime will also reduce the need for companies and groups to undertake elaborate planning, entailing, for example, the adoption of complex offshore structures, to reduce or eliminate the tax effects of future share disposals.

12. In some cases, companies will also benefit from no longer having to obtain valuations of shares at 31 March 1982 and agree those with the Inland Revenue. Rationalisation of UK holding structures may save the costs associated with redundant intermediate holding companies.

13. The measure will put the UK into a similar position to that in a number of other countries that have exemption regimes, will provide stability for business in the longer term, and will comply with the Government's key principles of competitiveness and fairness in modernising the corporate tax system.

Costs

14. The costs will include the compliance costs for business, the administrative costs for the Inland Revenue and the direct Exchequer costs.

15. In the November 2001 partial Regulatory Impact Assessment we set out our assumption that, overall, business will receive a compliance cost saving from this measure and asked for companies' views on the extent of these savings. Responses did not highlight the impact of the measures on companies' compliance costs, and this would be consistent with the assumption that such costs are not a significant issue for them. Although we are grateful to those who contributed to the consultation, the information we received from this process has not enabled us to quantify the expected compliance savings for business. We believe that the compliance cost savings to business will be modest but worthwhile.

16. The Inland Revenue's 1998/9 survey of company gains suggested that about 2,000 companies made gains on substantial shareholdings in that year. Taking account of companies that might expect to make such disposals but did not in that survey year, about 5,000 companies might expect to be directly affected by this exemption. Three-quarters of the yield on gains from share disposals came from just over 700 companies in 1998/9. This might suggest that about 1,000-1,500 companies (probably large and medium sized concerns) might be frequently disposing of substantial shareholdings. It is these companies that might take a structured approach to managing tax on such transactions and thus see a change in their compliance procedures. For the remaining companies affected, gains (or losses) may be dealt with on a more *ad hoc* basis as and when they arise.

17. For the Revenue, the reduction in administrative expenses will be negligible as the assessment of companies' gains will continue, albeit that some transactions are now excluded. There will, however, be a modest reduction in shares valuation costs as the number of March 1982 valuations that will be required in future will diminish as a result of the introduction of the substantial shareholdings regime.

18. There is an Exchequer cost from reduced Corporation Tax yield though the effective tax rate on companies' gains on substantial holdings has been relatively small. The expected cost of the relief is £70m in 2002/3, £130m in 2003/4 and £150m in 2004/5.

19. The above costs take into account the fact that under the exemption regime, losses will not be allowable where a gain would have been exempt, had a gain rather than a loss arisen. Work has been done simulating the impact of the

exclusion of gains and losses on substantial shareholdings. The findings suggest that gains on substantial shareholdings are more likely to be covered by losses than is the case for gains on shares generally. Furthermore, where groups had adopted complex offshore holding structures, disposals by offshore holding companies would not have given rise to a UK tax charge on any gain. Thus many disposals of substantial shareholdings before 1 April 2002 would not have generated a tax liability. The cost of introducing an exemption for gains is correspondingly lower than it might otherwise have been.

Impact on Small Business

20. The measure applies to all trading companies (where the necessary conditions are met). Smaller trading companies may be less likely to be realising substantial shareholdings but, for some, the benefits will be similar to those for larger corporates. Since smaller companies tend to pay tax on gains at a higher marginal rate than larger enterprises, probably reflecting the wider availability of losses in larger groups and the greater planning resources devoted to this area by larger concerns, smaller trading companies may obtain a proportionately greater benefit in terms of tax savings. Larger companies will be less fiscally inhibited from selling smaller subsidiaries to their management in cases where a management buy-out can lead to rejuvenation of their under-performing smaller holdings.

Securing Compliance

21. The basic compliance mechanism for securing compliance will be Corporation Tax Self-Assessment. Companies will be required to determine whether or not disposals are covered by the new regime when completing and submitting a return for an accounting period. Tax Inspectors will monitor compliance when examining relevant company accounts. The guidance to Tax inspectors on the operation of the exemption regime will be issued by the end of August 2002.

Monitoring and Evaluation

22. The Government has made a number of significant changes to the taxation of companies. There has been an open dialogue with companies and representative bodies. The Government will wish to continue monitoring the impact of these changes on the position of companies in the UK. The Government's overall objectives are to produce a modern, competitive and fair corporate tax regime that will provide stability for business in the longer term. It will not necessarily be possible to identify separately the precise contribution of each of the Government's reforms to this overall objective.

Consultation

23. There has been a wide-ranging consultation process on the design of a relief for gains on substantial shareholdings, culminating in the introduction of the exemption regime. During this time there has also been consultation with a group drawn from interested representative bodies.

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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:

A handwritten signature in black ink, appearing to read 'Dawn Primarolo', written in a cursive style.

Dawn Primarolo

Paymaster General

Date: 15 April 2002