Corporation tax reform

A consultation document

August 2003

HM TREASURY

Inland Revenue

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FOREWORD

Sustainable growth and economic stability are built on the platform of a thriving business sector. For that we need a modern tax system that underpins business competitiveness and raises revenues in a manner that best supports commercial decisions that businesses have to take on investment, on jobs and on legal and operating structures.

The publication of this document marks the next stage in the Government's strategy to achieve that objective through the reform of corporation tax. Since 1997 we have reduced the rate of corporation tax to 30 per cent and introduced a zero rate for the smallest companies. We have introduced new flexibility, removed distortions and taken the necessary measures to combat tax avoidance. However, further steps are needed if we are to ensure that the corporation tax regime meets the challenges of the modern business environment, does not impede the drive to greater economic efficiency, productivity and growth, and keeps pace with European and international developments.

This document invites comments on the options for the next stage in the reform process. In developing these options we have already benefited from extensive discussions held so far with business, following the publication in August 2002 of our previous consultation document. Those discussions have given us new insights, enhanced the evidence base for decisions and set a new standard for partnership between government and business in the development of the tax system. We welcome further contributions in this spirit of partnership.

As we seek to balance the objectives of fairness and competitiveness, ensuring that business continues to make a fair contribution to the funding of public services while responding effectively to international challenges that governments and business both face, I hope that we can all take full advantage of the opportunities provided by this document, to work for the development of a modern corporation tax system that will serve us well for the future.

Rt Hon Dawn Primarolo MP

Paymaster General

Comments are invited on the matters set out in this document. Please write to:

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Comments should reach him by 3 November 2003.

Responses to the consultation, together with the names and addresses of respondents, may be published unless confidentiality is specifically requested. We will assume that if you are replying by e-mail, any confidentiality disclaimer that is generated by your organisation's IT system is overridden unless you specifically include a request to the contrary in the main text of your submission to us. Please note that confidentiality cannot be guaranteed where a response includes evidence of a serious crime.

COMPETITIVENESS AND FAIRNESS

1.1 In August 2002, the Government published a consultation document *Reform of Corporation Tax*. This was followed by extensive discussions with business, and over 150 written responses were received.

1.2 In Budget 2003, the Government announced that the consultation would be taken forward with the publication of a further consultation document in the summer. The Government also explained that the reform of corporation tax would be considered in its broader international and European context (Economic and Fiscal Strategy Report, paragraph 3.53).

1.3 This document moves the process on to the next stage, taking forward the Government's programme of building a modern and competitive tax system. It summarises the responses to the earlier consultation and maps out ways in which the proposals in the August 2002 consultation document could be developed. It also discusses the maintenance of a fair and competitive UK corporation tax system.

PRINCIPLES OF CORPORATION TAX REFORM

1.4 The Government's corporation tax reforms since 1997 have promoted competitiveness and fairness, by reducing the tax rate while addressing economic distortions and tackling avoidance. In July 2001 the Government issued a consultation document *Large Business Taxation: the Government's strategy and corporate tax reforms* which developed these principles in more detail and set the direction for further reform.

1.5 The principles of competitiveness and fairness are reflected in recent measures, including:

- a new regime for the taxation of intellectual property, goodwill and other intangible assets to encourage business to take advantage of new opportunities in the emerging knowledge-based economy;
- an exemption for capital gains and losses on disposals of substantial shareholdings to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons;
- a volume-based R&D tax credit for larger companies to tackle the market failures that reduce such spending, building on the tax credit introduced in Finance Act 2000 for small and medium-sized companies; and
- a simplified and modernised regime for the taxation of loan relationships, derivative contracts and foreign exchange gains and losses, which streamlined the taxation of these often complex transactions while removing loopholes to ensure fair taxation.

1.6 These principles remain central to the Government's corporate tax strategy.

A COMPETITIVE TAX SYSTEM

1.7 The Government is committed to creating the best possible environment in which and from which to do business. This will help to sustain the UK's high levels of both inward and outward investment. The Government also has a long-term goal of increasing the sustainable rate of UK productivity growth. This will require new flexibility in product, capital and labour markets.

1.8 The tax system has an essential role to play in achieving both of these objectives. A competitive tax system is one which will make the UK an attractive location for business investment. While companies must make their fair contribution to the cost of public services, the tax system should not stand in the way of modern, flexible business practices that enhance productivity. The tax system should also aim to minimise its impact on the level, timing and composition of investment, except where there are market failures which make that investment sub-optimal.

Features of a competitive tax system

1.9 The Government firmly intends to maintain a competitive tax system. Some of the important features of such a system are as follows.

- **A low rate and a broad base.** High rates and narrow bases inevitably favour some types of business over others, distorting the economy. Low rates and broad bases spread taxation more evenly, thereby minimising any distortionary effects of taxation. A low rate and a broad base can also reduce incentives for tax avoidance.
- **Neutrality.** There should be an appropriate structure of reliefs for expenditure and losses. A tax system should aim to avoid favouring some investment at the expense of other, more productive, investment.
- **Flexibility.** The tax system should be able to accommodate the realities of today's business environment, allowing markets to respond flexibly to change. The tax system should not impede innovation in the development of new types of transaction, nor give them an unfair advantage. It should also respond to international and European developments affecting the competitiveness of the UK's tax system and to developments in business practices, including accounting standards.
- **Consistency and coherence.** If two sets of transactions have the same commercial result, then so far as possible they should have the same tax result. Commercial decisions on how to structure transactions can then be made undistorted by tax considerations, allowing the most productive choices to be made. Sometimes, however, the tax system must depart from this principle in order to maintain its integrity, taxing certain transactions in ways that limit the scope for tax avoidance.
- **Transparency.** The tax effects of commercial transactions should be as clear as possible, so that commercial decisions can be taken in full knowledge of their consequences.
- **Responsiveness to market failure.** Sometimes market failures arise, leading to sub-optimal allocations of resources, which can undermine growth and efficiency – or lead to socially undesirable outcomes. One response that the Government can make is to use the tax system to tackle market failures, for example by giving targeted incentives in areas where market forces give rise to sub-optimal levels of investment.

The case for continuing reform

1.10 While the Government has already taken many steps to improve the competitiveness of the tax system, there is an economic case for continuing reform. For example, further alignment of the tax system with economic concepts of income and profit would encourage businesses to invest in the most productive assets, and thereby promote productivity and growth. More generally, in order to maintain the competitiveness and integrity of the tax system, the Government needs to keep the system under review against the evolving business environment in which it operates, including the wider issues discussed in Chapter 3.

1.11 The Government is also committed to a sustainable framework for the public finances, consistent with its fiscal rules. Within this context, corporation tax has a role to play as an "automatic stabiliser". Corporation tax receipts tend to rise faster than output when economic growth is above trend, and fall relative to output when economic growth is below trend. This helps to stimulate demand in the economy during a slowdown, and to cool demand in a boom. It also has the advantage of aligning businesses' tax liabilities more closely with their ability to pay. In developing its reform proposals, therefore, the Government will also consider how they affect the role of corporation tax as an automatic stabiliser of the economy.

DEVELOPMENTS IN ACCOUNTING STANDARDS

1.12 One specific feature of the modern business environment which needs to be taken into account in order to maintain the competitiveness of the tax system is the ongoing development of International Accounting Standards (IAS) and their application to UK companies. The Government recognises that accounting standards are in a state of rapid development as the move towards the adoption of International Accounting Standards gathers pace. This will have an impact on the existing tax system, where measures of taxable and accounting profit are already closely aligned in a number of areas. It may also have an impact on some aspects of the reforms set out in Chapter 2 of this document, which aim to align tax and commercial profits over a wider range of the corporate tax system.

1.13 From 1 January 2005 the consolidated accounts of all listed companies will have to be prepared on the basis of IAS. It will also be possible to prepare the accounts of individual companies on this basis. UK Generally Accepted Accounting Practice (GAAP) is in any event moving towards convergence with IAS, even in cases where IAS is not formally adopted for individual company accounts.

1.14 The Government will monitor these developments carefully and will consider whether changes to existing tax law are required where accounts prepared under IAS, or revised UK GAAP, cease to give an appropriate result for tax purposes compared with current UK GAAP. Many of these issues are already being discussed with interested parties as part of existing arrangements for ongoing consultation (for example, the Loan Relationships and Derivative Contracts Working Group). To ensure that all potentially relevant issues are identified, a co-ordinating group has been set up under the auspices of the Business Tax Forum.

1.15 The Government will also be looking carefully at the impact of developments in accounting standards on the current proposals for reform. These issues are discussed in more detail in Chapter 2.

THE STRUCTURE OF THIS DOCUMENT

1.16 Chapter 2 of this document outlines how the Government intends to take forward the proposals set out in last August's consultation document in line with the objectives set out above. Chapter 3 sets out proposals for reform of the rules on transfer pricing and thin capitalisation, and also considers wider issues in the context of the need to maintain a fair and competitive tax system.

1.17 This document is accompanied by a series of background notes. They are available on the Internet at www.inlandrevenue.gov.uk/consult_new. Copies can also be obtained free of charge from the Inland Revenue Visitors Information Centre, G27 Ground Floor, South West Wing, Bush House, Strand, London WC2B 4RD, or by telephoning 020 7438 6533.

1.18 Background Notes A, B and C relate to topics covered in Chapter 2. They are as follows:

- A – Rationalisation of the schedular system
- B – The tax differences between trading companies and investment companies
- C – The taxation of capital assets.

1.19 The other background notes are as follows:

- D – Summary of consultation responses
- E – Partial regulatory impact assessment
- F – Summary of questions (this includes both the questions in this document and the detailed questions in Background Notes A, B and C).

2 TAKING FORWARD THE AUGUST 2002 PROPOSALS

BACKGROUND

2.1 The August 2002 consultation document was the latest step in the Government's continuing programme to produce a modern, competitive tax regime that reflects the realities of the business environment.

2.2 The document built on the reforms that had been implemented since 1997 and the principles and objectives set out in the consultation document *Large Business Taxation: the Government's strategy and corporate tax reforms,* issued in July 2001.

2.3 Among the objectives of the reforms since 1997, the two most relevant to the changes explored in the August 2002 document are:

- to reduce tax distortions; and
- to remove outdated and ineffective restrictions.

2.4 The proposals in the August 2002 document also took into account representations made by business. These had advocated modernisation of the corporation tax system in order to give greater transparency and certainty in the taxation of particular types of transaction, and had reflected a desire to see taxable profits and commercial profits move closer together. Business had also sought greater clarity about the overall policy framework within which any changes would be made.

THE AUGUST 2002 DOCUMENT

2.5 In the August 2002 consultation document, the Government explored three areas for potential further reform:

- the tax treatment of capital assets not covered by earlier reforms – the document discussed how the assets remaining within the chargeable gains regime might be moved into an income regime and considered how relief might be given for capital expenditure;
- reform of the schedular system as it applies within corporation tax, with various possible options for rationalisation; and
- the differences in the tax treatment of trading and investment companies.

THE CONSULTATION

2.6 During the consultation period following publication of the August 2002 document, extensive discussions took place with representatives of business. In addition, over 150 written responses were received from a wide range of businesses and other interested parties. Further meetings have been held with representatives of particular sectors to discuss the issues in greater depth. The Government is grateful for all the feedback received and looks forward to continuing this constructive consultation process.

2.7 There was general support for the Government's objective of modernising the corporation tax system and respondents welcomed the opportunity to consult on further reforms.

2.8 The proposals to rationalise the schedular system and review the distinction between trading and investment companies were particularly well-received. The responses to the proposals for taxing capital profits and relieving capital expenditure were more mixed. The Government considers that the proposals set out later in this chapter will meet the main concerns of business and enable the consultation to move forward constructively.

2.9 A fuller summary of the responses is contained in Background Note D. In brief:

- the schedular system is widely seen as outdated and in need of reform. While the vast majority of responses favoured abolition of all schedular distinctions, any freeing up of loss relief would be seen as valuable and respondents recognised that there might be cost constraints on how far the Government could go;
- the distinction between trading and investment companies is seen as unnecessary. The principal area of concern is the different rules for the treatment of expenses incurred by the two types of company. There is some enthusiasm for removing the distinctions between trading and investment companies for shareholder reliefs. In general, however, these are regarded as of lower priority in the context of the proposed reforms;
- there is concern at the possibility of taxing unrealised gains on investment property (which might arise from a combination of likely accounting changes under the move to International Accounting Standards (IAS), taxing the profits on capital assets as income and following the accounts to achieve this);
- there is strong support for retaining some kind of roll-over relief within a new regime;
- there is also support for retaining indexation relief, though an acceptance that within the context of a balanced package it might be possible to dispense with future indexation accruing after the commencement of a new regime;
- there is concern at the possibility of a lengthy transition from taxing capital profits as chargeable gains to taxing them as income, during which parallel regimes might be necessary;
- there are mixed views on the idea of replacing capital allowances with relief for commercial depreciation. A number of sectors are concerned about the extent to which this would reduce the cash-flow advantages of existing capital allowances for assets with a relatively long life; and
- some sectors would welcome the advantages of allowing relief for depreciation on commercial buildings. But concerns were expressed about a hybrid regime, allowing commercial depreciation on buildings but retaining capital allowances on plant and machinery.

THE GOVERNMENT'S RESPONSE

2.10 As announced in the 2002 Pre-Budget Report and confirmed in this year's Budget, the Government intends to take forward reforms in all three areas explored in the August 2002 document.

2.11 In each of these areas, outdated features inherited from the last two centuries are still fundamental to the computation of corporation tax liability. Some of these features may distort commercial decisions, reducing economic efficiency and undermining the competitiveness of UK businesses. They may also reduce certainty of outcome and increase compliance costs, because the tax categories no longer fit the commercial transactions to which they must be applied. And they may impose ineffective restrictions, which have an impact only on those without the resources to plan around them.

2.12 The Government recognises that the transition from the present position to a reformed system will require careful management. There are risks (both for companies and for the Exchequer) in moving too rapidly away from long-established, well-understood principles, and in certain areas a longer-term or staged approach may be required.

A MORE MODERN REGIME – THE ACCOUNTS AS A STARTING POINT

2.13 Within the current corporation tax regime there is an inconsistency between income and capital items. The taxation of income is based on identifying specific sources of income. To be deductible, income related expenditure must fall within the rules for computing the taxable amount from a particular source of income, or must be within the scope of the management expenses rules. Capital expenditure is generally disallowed in computing income and may qualify for capital allowances instead. The rules for computing income from most sources (such as trading profits) are already closely aligned with the accounting treatment.

2.14 For capital items, it is usually necessary to establish that there has been a disposal of an asset for a capital gain to arise, and expenditure must fall within the rules for computing capital gains in order to be deductible. The rules for computing capital gains bear little relation to amounts appearing in a company's accounts. The availability of various reliefs, such as indexation allowance, which are not available for income, may distort commercial decisions by favouring investment in assets that generate gains rather than income. Furthermore, certain items of expenditure reflected in the accounts, for example on improvements to an asset that are not reflected in the state of the asset when sold, are not deductible.

2.15 There is scope within this system for amounts received by business to be non-taxable even though they appear within a company's accounts. Equally there is scope for business expenditure to fall outside any provision for relief. These cracks in the system can lead to uncertainty and can distort commercial decisions; they may lead to transactions being structured in a particular way to ensure that relief is available for particular expenditure, even when the structure is sub-optimal from a commercial perspective.

2.16 A more coherent, comprehensive tax base for companies might take a company's accounts as the starting point for computing **all** taxable profits, not just income profits. The accounts represent the totality of the company's commercial activities, and using them at least as a starting point for taxation would bring all income and expenditure, subject to any specific exclusions, within the scope of charge or relief.

2.17 There may also be advantages, both in terms of compliance costs and transparency, in starting from a base that is relevant for purposes other than tax. It will generally be less onerous to start the tax computation from a figure in the accounts, even if adjustments have to be made to that figure, than to prepare a computation specifically for tax purposes. The audit requirement (where it applies), and the legal requirement to show a true and fair view, provide a degree of quality control on those accounts figures that carries over to the tax computation.

2.18 In seeking to align the corporate tax system more closely with the accounts, the Government is aware that any proposals will need to take account of the developments in accounting standards mentioned in Chapter 1. The Government will be looking carefully at the way in which these developments affect the current proposals for reform. In particular, the following areas are likely to be relevant and are discussed in more detail in Background Note C:

- IAS 39 and any new UK Financial Reporting Standard – FRS (accounting for financial instruments – as it affects the accounting treatment of shareholdings);
- IAS 40 (accounting for investment properties);
- the joint Accounting Standards Board (ASB) and International Accounting Standards Board (IASB) project to develop a comprehensive income statement – effectively combining the current profit and loss account and the statement of recognised gains and losses.

2.19 The Government also recognises that it may not be appropriate for the tax base to follow the accounts in all respects, and the August 2002 consultation document indicated the Government's readiness to temper the effect of particular accounting rules where there were good policy reasons for doing so.

2.20 There are a number of possible policy reasons for departing from the accounts. The Government may wish to use the tax system to promote economic efficiency by addressing market failures (for example, by giving enhanced capital allowances for energy saving technology). Adjustments to the accounts may also be necessary to ensure that the tax system is fair (for example, to reflect an arm's-length price for transactions between related parties).

2.21 Finally, the Government recognises that it is vital that tax policy should take account of practical issues. So there may be a case for departing from the accounts where the tax consequences of a particular accounting treatment would cause difficulties in practice. An example of this is the treatment of gains on revaluation of investment properties, discussed further in paragraph 2.37 below and in Background Note C.

SUMMARY OF DETAILED PROPOSALS

2.22 The remainder of this chapter summarises the Government's proposals in each of the three areas explored in the August 2002 document. The issues are covered in more detail in Background Notes A to C. This chapter also discusses capital allowances on leased assets.

Schedular reform

2.23 The Government is considering options to reform the schedular system of taxation as it applies to companies, to produce a more coherent, flexible regime appropriate to the taxation of corporate business income.

2.24 The current system, based on income tax rules dating back to the early 19th century, divides a company's income into a number of different categories according to its source. The rules for offsetting losses from different sources vary, but the practical effect in many instances is to restrict the offset of losses (particularly losses carried forward) against profits from another source.

2.25 There is an economic case for loss relief as an integral part of taxing profits over the business cycle, and as a necessary feature of a system that seeks to avoid discouraging investments with high commercial risk. To provide more flexibility in offsetting losses, the Government is considering two options for reform which have emerged as front-runners from the first round of consultation:

- full pooling of all sources of income; and
- pooling all sources of trading income and income from property.

2.26 Full pooling was the favoured option among respondents to the first round of consultation. But, as mentioned earlier, responses also recognised the possible cost constraints, and indicated that significant benefits could be achieved by the more limited option of pooling all sources of trading and letting income.

2.27 The implications of each option are explored in Background Note A.

The tax differences between trading and investment companies

2.28 In the next stage of consultation on this strand of reform, the Government proposes to focus on the issue which emerged as a particular priority from the first round: the different expenses regimes for investment companies and trading companies.

2.29 Background Note B discusses how the system might be streamlined and simplified by:

- removing the requirement for a company to qualify as an investment company in order to obtain relief for the expenses of managing its investments; and
- aligning the rules on management expenses (for example, the rule on the timing of the deduction) more closely with the accounting treatment.

2.30 These changes would increase certainty for companies, remove the need for groups to take steps to ensure that management expenses fall within a company qualifying for relief, and facilitate group re-structuring.

2.31 The Government is also considering two other areas that have been identified by business as of particular importance:

- the possible extension of the substantial shareholdings exemption to disposals by shareholding companies that are investment companies. This issue is discussed in more detail in Background Note B, together with the reasons why the Government does not at present favour extending the exemption to disposals of shares in investment companies; and
- the possible extension of roll-over relief beyond its present scope. Roll-over relief is discussed further in paragraphs 2.38 and 2.39 below and in Background Note C alongside the proposals for the taxation of capital assets.

The taxation of capital assets

2.32 The Government's strategy continues to be:

- to move to a more coherent, consistent and comprehensive system for taxing capital profits and relieving capital expenditure; and
- so far as possible, to reduce the distortions within the current regime – for example, between the taxation of capital and income profits and between relief for expenditure on different types of asset.

2.33 To assist in achieving these objectives, the Government remains attracted to the approach of using the commercial accounts at least as a starting point over a wider range of the corporate tax system, as discussed in paragraph 2.16 above. The intention is to replace the current chargeable gains regime with rules that align more closely with the accounting treatment. Different approaches may be required for different types of asset: the issues are discussed in more detail in relation to real property and shares in Background Note C.

2.34 Background Note C sets out a range of options for:

- transition to a new regime; and
- the extent and form of any pooling of capital profits and losses with income profits and losses.

Adjustments to accounting profits

2.35 It is recognised that, in using the accounts as a starting point for the taxation of capital assets, adjustments will be required in certain circumstances.

2.36 One such instance is the taxation of gains on investment properties, where the move to IAS is likely to lead to "fair value" accounting, under which measurement of company performance will include changes in the value of assets held on the balance sheet. There is a good economic case for taxing increases in valuation: the wealth of a company owning an appreciating property increases year by year but this increase in wealth remains untaxed. By contrast, if the company has financed the purchase of the property through borrowing, the costs of borrowing are generally an allowable expense for tax purposes.

2.37 In the particular case of real property, however, the Government recognises the considerable practical difficulties that companies would face in paying an annual tax on revaluations and on balance regards this as an instance where the effect of following the accounts should be tempered. Any new regime would therefore impose payment of tax on appreciation of real property only on disposal.

2.38 The Government also recognises the case for adjusting accounting profits in order to continue to provide a form of roll-over relief for replacement of business assets. Background Note C suggests the form that such a relief might take, modelled on the relief available for the replacement of intangible assets.

2.39 There may also be an economic case for giving the same treatment to let commercial property as is given to property held by a trader and used for the purposes of a trade. However, the case for extending roll-over relief to assets held to produce an investment return that is partly in the form of capital appreciation is perhaps less compelling. This issue will be kept under review as the reform proposals develop.

2.40 As announced in Budget 2003, the Government will also discuss with the property industry the evidence for the effectiveness of further measures to encourage an efficient and flexible commercial property market.

Abolition of future indexation

2.41 It is envisaged that, as part of a balanced package of measures, indexation will no longer be available on capital profits accruing within the new regime. The availability of indexation relief on capital gains within the current system introduces a distortion favouring investment in assets that generate gains as opposed to income. While the Government acknowledges that, historically, indexation relief has recognised an earlier period of high inflation and has been valued by those holding assets for the long term, it considers that the relief has a diminishing significance in the current stable macroeconomic climate. Relief for indexation accrued up to the commencement of the new regime will, however, be preserved.

Relief for capital expenditure

2.42 The consultation process has generally demonstrated that the current system of capital allowances has broad support across most sectors of the business community, as a means of reflecting the costs of investment over time. Consultees have drawn attention to several features of the current system which they would like to see retained. However, the consultation process has also highlighted a number of distortions and complexities in the system, which could potentially be addressed as part of a wide-ranging reform.

2.43 In principle, there is an economic case for a system aligned as closely as possible with the concept of "economic depreciation", that is, for a system that reflects the rates at which assets depreciate in value. A system based more closely on economic depreciation might reduce distortions, improving the allocation of investment in the economy as a whole and therefore increasing its contribution to output and economic growth.

2.44 Relief for capital expenditure in excess of economic depreciation would, however, be of benefit to the economy in cases where there are market failures that would otherwise result in under-investment. In this context it should be emphasised that, even if changes were made to the system for providing a tax deduction for capital expenditure, the Government would remain committed to retaining a mechanism for delivering specifically targeted incentives, such as the 40 per cent first-year capital allowances for small and medium-sized enterprises, if necessary through equivalent alternative mechanisms. Background Note C suggests some alternative options for delivering such allowances.

2.45 The current capital allowance regime departs from the principle of economic depreciation in some specific areas. Firstly, capital allowances are not currently available for all types of investment expenditure. For example, allowances are available for the cost of industrial and agricultural buildings, but not for commercial buildings. Secondly, the timing of relief given on plant and machinery under the capital allowances regime may be substantially out of line with the economic depreciation of the assets involved.

2.46 In principle, addressing these distortions could have a positive impact on the economic efficiency of investment. However, the Government also recognises that radical reform in this area could redistribute the tax burden significantly between different sectors of the economy. It is also clear that reform needs to be practical, and should be as clear and simple to apply in practice as possible.

2.47 One option, discussed in the August 2002 consultation document, would be to move towards relief based on commercial depreciation. Some respondents saw benefits in such a move. In principle, it might be expected to bear a closer relationship to the actual rate of economic depreciation, and by linking tax liabilities more closely to commercial accounts it could lead to a simpler system. However, concerns were also expressed, particularly by sectors which invested heavily in plant and machinery with a long useful economic life,

where a relief based on commercial depreciation would provide tax relief at a less generous rate than the current regime. A number of respondents also highlighted practical difficulties, including the risk that, by introducing tax considerations into the judgement about commercial depreciation, biases might be introduced in the commercial accounting treatment of capital assets.

2.48 Another option would be to reduce distortions by increasing the number of different categories for plant and machinery expenditure. This could ensure that capital allowances more accurately reflected the economic lives of those assets. The Government recognises that this might introduce further complexity, but that benefits could arise from a regime with fewer distortions.

2.49 The Government is not committed to change in this area, given that there would be both advantages and disadvantages to the above options. Further consultation will play a key role in deciding whether changes should be made in order to move closer to economic depreciation.

2.50 The Government would therefore like to open up a wider debate on the role of capital allowances and their effect on investment decisions. In particular, the Government is keen to seek views on the following issues:

- whether economic efficiency and the quality of investment would be improved by a system of relief for capital expenditure which aimed to reflect economic depreciation more closely;
- if so, the methods by which such a closer approximation might be achieved;
- the extent to which capital allowances influence the level and timing of investment and the factors which are most important in having any such influence (such as rates, flexibility of allowances or certainty of allowances); and
- any features of the current capital allowances system that are attractive to business for other reasons.

2.51 The limitation of allowances to certain types of building is a specific distortion affecting investment in property, which may be contributing to an under-investment in that asset class. A more comprehensive relief for the cost of buildings could be introduced via either:

- a relief for the cost of buildings based on commercial depreciation; or
- a relief based on a fixed rate of annual allowance for expenditure on commercial, industrial and agricultural buildings.

2.52 Background Note C sets out the second option in more detail. Under this option, it is envisaged that the new relief would replace and extend the current Industrial Buildings Allowances and Agricultural Buildings Allowances. At the same time, there might be a case for re-considering the boundary between plant and buildings, to reflect the greater integration of plant within modern buildings.

LEASING

2.53 The August 2002 document acknowledged that the possible changes discussed had particular implications for leased assets and that the Government would want to give special consideration to their treatment.

2.54 The current tax rules, which give capital allowances to the lessor, do not always lead to a consistent treatment of essentially similar investment decisions and may therefore distort the decision between different types of finance.

2.55 As part of the wider debate on the role of capital allowances, the Government wishes to consider the case for remedying this distortion by moving entitlement to capital allowances on leased plant and machinery from lessors to lessees for leases which are essentially financing transactions. In general, the same allowances would be given to lessees as would be given if they had borrowed money and bought the assets.

2.56 Generally Accepted Accounting Practice (GAAP) recognises two types of lease: finance leases, under which substantially all the risks and rewards of ownership pass to the lessee, and operating leases, which are all other leases.

2.57 In practice, leases of plant and machinery exhibit a range of characteristics that place them on a spectrum between a pure financing transaction and a basic operating lease. As a result, some leases that are classified as operating leases for accounting purposes are in fact essentially financing transactions. Therefore, in order to achieve appropriate tax treatment for all leases that are essentially financing transactions, it would be necessary to introduce a special statutory definition that would identify such leases. This definition would cover all finance leases and a small proportion of leases that, although they were shown as operating leases in the accounts, were essentially financing transactions.

2.58 Where leases of plant and machinery were effectively financing transactions, lessors would be taxed on the finance income elements of rental receipts, rather than on their gross rental receipts. Lessees would be allowed to deduct the finance cost elements of rental payments in computing their taxable profits. Capital allowances would replace the deductions that lessees currently receive for the depreciation element of rental payments.

2.59 Such changes would not affect the vast majority of operating leases. They would also not affect leases entered into before the commencement date of any new regime. They would:

- remove a distortion of the choice between a loan and a lease that is essentially a financing transaction, allowing the choice to be made on commercial grounds such as the level of security for the financing;
- make it possible to repeal the current rules which restrict capital allowances for UK lessors to overseas lessees. The repeal would increase opportunities for UK lessors to engage in cross-border leasing; and
- make it possible to allow lessees to benefit from first-year allowances.

2.60 It would be difficult to limit such a change to the taxation of corporate entities. Therefore the changes considered here would apply to unincorporated businesses as well as to companies.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

The Government would welcome views generally on the ideas discussed in this chapter and specifically on the following points:

Schedular reform

- What would be the extent of the benefits delivered by full pooling?
- What would be the extent of the benefits delivered by pooling all sources of trading income and income from property?
- Would there be any disadvantages of either form of pooling, or any difficulties in implementation?

The tax differences between trading and investment companies

- Comments are invited on the possible removal of the requirement to qualify as an investment company in order to obtain relief for the expenses of managing investments. To what extent would group re-structuring be facilitated by such a change?
- Comments are invited on the possible closer alignment of the management expenses rules with the accounting treatment (for example, by following the accounts in relation to the timing of the deduction). Would there be any disadvantages in such a change?
- What would be the benefits of the possible extension of the substantial shareholdings exemption to shareholder companies that are investment companies? Would there be any disadvantages?

The taxation of capital assets

- To what extent would it be appropriate to use the accounts as a starting-point for the computation of capital profits? What exceptions from accounts treatment would be appropriate?
- Would economic efficiency be improved by a system of relief for capital expenditure which aimed to reflect economic depreciation more closely?
- If it is considered desirable for relief to approximate more closely to economic depreciation, how might this best be achieved?
- To what extent do capital allowances influence the level and timing of investment in practice?
- To the extent that capital allowances do have an influence, what features of the capital allowances system are most important? Is it, for example, the rate of allowance, or other factors such as the flexibility or certainty of the regime?
- What features of the current capital allowances system are attractive to business for other reasons?
- What would be the relative advantages and disadvantages of relief for the cost of buildings based on commercial depreciation or based on a fixed rate of annual allowance?

Leasing

- What are respondents' views on giving capital allowances to lessees for leases which are essentially financing transactions?
- What practical difficulties might be faced and how might they best be overcome?

3 THE WIDER CONTEXT

3.1 The commercial world is evolving rapidly. At the same time, the context set by other countries' tax systems, by international agreements and by EU law is also evolving.

3.2 The corporation tax system has to meet the challenges of a competitive international environment and must also be kept robust against any legal challenges under EU law, particularly where those challenges have the potential to undermine international agreements.

3.3 The ongoing reform of corporation tax must reflect both of these influences. The discussion launched in this chapter is intended to draw out further the business view of how to respond.

TRANSFER PRICING

3.4 One fundamental issue for tax systems is how they should deal with transactions between related parties. Such transactions may or may not be made on the same terms as arm's-length transactions.

3.5 The corporation tax system has for many years included rules to deal with these issues, under the headings of transfer pricing and thin capitalisation.

3.6 Transfer pricing rules exist to ensure a fair division of profits between related entities. They require transactions between related enterprises, such as companies in the same group, to be priced as if they had been between enterprises dealing at arm's length. If a transaction would not have taken place at all between unrelated enterprises, then it could be treated for tax purposes as if it had not occurred.

3.7 Transfer pricing rules are operated within the internationally accepted framework developed through the Organisation for Economic Co-operation and Development (OECD) to ensure that the taxable profits of multinational businesses are allocated fairly between the countries in which they are operating. In 1998 the Government overhauled the UK's transfer pricing code, explicitly recognising the OECD guidelines on transfer pricing in UK law.

3.8 Except in limited circumstances, the UK legislation on transfer pricing applies only where one party to the transaction is not within the charge to UK tax. This aspect of the rules has led to uncertainty about the appropriateness of the UK rules in the light of the evolving jurisprudence of the European Court of Justice (ECJ).

3.9 The Government regards the transfer pricing rules as an essential part of maintaining a fair tax system. Any uncertainty about whether the scope of the rules is appropriate therefore needs to be addressed. In order to put the matter beyond doubt, the Government proposes to extend the scope of the transfer pricing legislation to transactions between all related enterprises, even where both are in the UK. This will also remove some opportunities for artificial manipulation away from arm's-length terms.

Mitigation

3.10 The Government recognises, however, that the extension of transfer pricing rules to transactions within the UK has the potential to impose significant new administrative work. It will therefore take steps to mitigate any additional burden as far as possible, while ensuring that the system remains robust. In particular:

- for smaller businesses, the relatively low value of transactions with related parties means that the administrative work required to apply transfer pricing rules, whether cross-border or within the UK, is generally disproportionate to the amount of tax at stake. The aim will therefore be to ensure that any new rules do not affect these businesses. How best to achieve this, while ensuring that wealthy individuals cannot avoid tax by diverting personal income to offshore companies, is an issue which the Government wishes to discuss with business and other interested parties; and
- more generally, the Government will consider whether any changes to the existing transfer pricing rules and guidance, for example on documentation, might be appropriate in conjunction with their extension to transactions between related UK parties.

The elimination of double taxation

3.11 Where double taxation arises as a result of the application of transfer pricing rules to cross-border transactions, it can be addressed through the mutual agreement procedure in bilateral treaties. The Government will ensure that there is an appropriate way of addressing any domestic double taxation.

THIN CAPITALISATION

3.12 The thin capitalisation rules disallow excessive interest paid between certain related parties. Where they operate, therefore, they prevent the re-allocation of profit within a group by one group member borrowing from another group member and paying excessive interest.

3.13 Transfer pricing legislation applies to goods and services of all descriptions, including the provision of a loan. Where a loan is provided on different terms than would apply in the absence of a relationship between the parties, the arm's-length terms must be applied. To the extent that a loan would not have been provided at all, the interest is wholly disregarded for tax purposes.

3.14 While the thin capitalisation restrictions operate in a slightly different way from transfer pricing rules, the Government sees the extension of transfer pricing to UK transactions (and the minor modifications to the transfer pricing rules that would be required as part of that extension) as an opportunity to subsume the necessary protection against thin capitalisation within the transfer pricing regime. So with these changes in the transfer pricing rules, the Government will be able to repeal the existing thin capitalisation legislation.

3.15 The thin capitalisation legislation includes grouping rules, but the Government does not intend to transfer these rules to the transfer pricing legislation. The application of transfer pricing legislation to loans and interest will be on a company-by-company basis, just as it is for other transactions. The fact that transfer pricing legislation applies to a transaction or a series of transactions, so that a number of transactions can be considered together, will allow transfer pricing legislation to be applied with the same practical effect as the thin capitalisation restrictions.

Mitigation

3.16 As mentioned in paragraph 3.10 above, the Government will take steps to mitigate any additional burden of extending the transfer pricing rules to transactions within the UK. This applies equally in the context of thin capitalisation. In particular, there may be a case for specific mitigation in relation to small loans, possibly subject to an anti-fragmentation rule to prevent abuse.

Re-characterisation

3.17 The thin capitalisation legislation does not, however, merely disallow interest in certain circumstances. It re-characterises disallowed interest as a distribution of profits, and that has further tax consequences. One consequence is that there is no requirement to deduct tax at source from the disallowed amount because it is no longer treated as UK source interest in the hands of the recipient.

3.18 If the thin capitalisation rules are repealed, there will be no re-characterisation and any interest disallowed would still be treated as interest. The existing tax rules do not generally allow excessive interest to be paid to a non-resident without deduction of income tax at the UK domestic rate. The Government will therefore consider ways in which this potential double taxation might be mitigated.

LOOKING FURTHER FORWARD

3.19 The previous sections of this document have set out the detail of the Government's thinking on the continuing modernisation of aspects of the UK corporation tax system.

3.20 It is inevitable that the UK's corporation tax system will need to be kept under review, with periodic modernisation to take account of:

- continued rapid change in the way that business is organised and carried out;
- ever-increasing globalisation;
- the breaking down of barriers to trade, both within the EU Single Market and worldwide;
- the introduction of International Accounting Standards;
- the developing framework of international agreements on the division of taxing rights between countries; and
- the evolving jurisprudence of the UK courts and of the ECJ.

3.21 The Government has already set the direction for future reform, based on the twin principles of competitiveness and fairness. These principles will remain central to its corporate tax strategy. They require that all businesses should contribute fairly to corporation tax revenue, irrespective of whether they operate globally, in a few countries or are based wholly within the UK.

3.22 The Government has also made clear its determination to ensure that the UK's corporation tax system is robust against legal challenges, to reduce uncertainty and to ensure that the system remains fair by minimising any risk of manipulation.

3.23 Business has expressed a desire for a wider-ranging dialogue on the developing international business context and the ways in which the UK's corporation tax regime should be developed.

3.24 The Government would welcome such a dialogue and would wish to identify with business both the areas for discussion and the substance of any changes that might be appropriate.

3.25 Continuing its existing strong commitment to consultation on tax reform, the Government looks forward to discussing further modernisation of the UK's corporation tax system with business and other interested parties. And it would particularly welcome comments on priorities for consideration of further action to keep the corporation tax system up-to-date, taking into account the principles of competitiveness and fairness.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

The Government would welcome views generally on the ideas discussed in this chapter and specifically on the following points:

- What will be the effect of extending the transfer pricing rules to UK/UK transactions?
- How could the administrative requirements best be mitigated, particularly for smaller businesses?
- Are there any difficulties arising from the use of transfer pricing legislation in relation to interest paid by thinly capitalised companies?
- What are respondents' views on the issues raised in the final section of this chapter, taking into account the principles of competitiveness and fairness?

About the Consultation Process – Code of Practice on Written Consultation

CONSULTATION CRITERIA

1 Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.

2 It should be clear who is being consulted, about what questions, in what timescale and for what purpose.

3 A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.

4 Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.

5 Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.

6 Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.

7 Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

The Inland Revenue confirms that, where possible, these consultation criteria have and will continue to be followed. The main questions are summarised at the ends of Chapters 2 and 3.

If you have any complaints about any element of the consultation process leading from the issue of this document, please contact:

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