Reform of Corporation Tax

A consultation document

August 2002

HM TREASURY

Inland Revenue

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

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Comments should reach him by 29 October 2002. Your response may be made public unless you say you want it kept confidential. If you have any questions about this consultation please contact Peter Marriott.

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INTRODUCTION

I.1 The Government is considering further reforms to the corporation tax system in order to produce a regime that is modern and competitive and reflects the realities of the business environment. This document seeks the views of business and other interested parties on three potential further reforms:

- the tax treatment of capital assets not covered by earlier reforms;
- rationalisation of the schedular system; and
- the differences in the tax treatment of trading and investment companies.

BACKGROUND

I.2 In July 2001 the Government published a consultation document *Large Business Taxation: the Government's strategy and corporate tax reforms*. It set out the Government's strategy for modernising corporate taxes and included detailed proposals for a new relief for capital gains on substantial shareholdings held by companies.

I.3 That followed the March 2001 technical note *A Review of Small Business Taxation*, which considered simplification for small companies through the closer alignment of their profits for tax purposes with those reported in their accounts.

I.4 The July document also announced an Inland Revenue review of links with business on administrative matters, on which a report was published in November 2001.

THE GOVERNMENT'S STRATEGY FOR CORPORATION TAX

I.5 The July 2001 document set out the key criteria for reform. Within the basic framework of revenue raising, these are:

- business competitiveness – this means:
  - removing tax distortions, to ensure that decision-making is driven by commercial factors rather than by tax considerations; and
  - promoting productivity by tackling market failures that ultimately undermine growth, such as under-investment in research and development.
- fairness, a balance to competitiveness – this means:
  - ensuring that individual businesses pay their fair share of tax in relation to their commercial profits and compete on a level playing field; and
  - where the tax system is the best policy instrument, using it to correct market failures that impose wider costs on society.

I.6 The key objectives underpinning the reforms made since 1997 have been:

- maintaining a low rate, broad-based system. Low rates and a broad base facilitate decision making that is driven by commercial factors;

- reducing tax distortions and market failures;
- removing outdated and ineffective restrictions; and
- countering tax avoidance. There is always a need for the Government to ensure that companies pay their fair share of tax and do not gain an unfair competitive advantage through artificial tax planning.

1.7 These objectives continue to guide the direction of further reform to the corporate tax system.

REVIEW OF SMALL BUSINESS TAXATION

1.8 On 7 March 2001 the Inland Revenue published a Technical Note *A Review of Small Business Taxation* seeking views on ways to reduce regulatory and compliance costs. It set out for consideration the possibility of aligning the measure of taxable profits much more closely with the commercial results shown in company accounts.

1.9 While there was strong support for the general aim of simplifying the system, there was no consensus on the means. Many who commented thought that closer alignment of tax and commercial profits only for small companies would be impractical and would introduce further complexity. Some thought it important to retain existing incentives such as capital allowances and that any worthwhile changes should be made for all companies, not just for small companies.

REVIEW OF LINKS WITH BUSINESS

1.10 The Government believes that a modern corporate tax system must be supported by a modern tax administration. The July 2001 consultative document on corporate tax reform also announced an Inland Revenue review of links with business on administrative matters with the aim of bringing forward recommendations to ensure that the administration of the corporate tax system keeps pace with the changing business environment and legislative programme, and is forward looking and supportive of business.

1.11 The report, *Review of Links with Business,* published in November 2001, contained 40 recommendations covering many aspects of the interaction between the Inland Revenue and business. It identified, among other things, the need for the Inland Revenue to gain a better understanding of the way business operates and its commercial drivers through more frequent and direct dialogue between the Inland Revenue and business, and more informed training and development.

1.12 All the recommendations are being taken forward, and the Inland Revenue will publicise progress against the action plan via its website.

BUDGET 2002 CHANGES

1.13 Budget 2002 announced further significant reforms of the corporation tax system in line with the key principles set out in the July 2001 consultative document. These include:

- a new regime for providing relief to companies for the costs of intellectual property, goodwill and other intangible assets to encourage business to take advantage of new opportunities in the knowledge-based economy;

- an exemption for capital gains and losses on substantial shareholdings to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons;
- a simplified and modernised regime for the taxation of corporate debt, derivative contracts and foreign exchange gains and losses;
- a new tax credit to boost research and development by larger companies; and
- the modernisation of the taxation of foreign companies operating in the UK through branches.

1.14 The 2002 Budget also announced the findings of the *Review of Small Business Taxation* and the Government's intention to consult on further general corporation tax reform.

WHAT CHANGES DOES BUSINESS WANT?

1.15 In representations, businesses and their advisers have advocated that modernisation should:

- simplify the corporation tax system;
- provide greater clarity as to the overall policy framework within which any future changes would be made; and
- give greater transparency and more certainty in the taxation of particular transactions.

1.16 In line with these high-level principles, they have argued in favour of:

- elimination of tax nothings;
- abolition of the capital/revenue divide;
- abolition or rationalisation of the schedular system; and
- relief for the depreciation of assets not eligible for capital allowances.

1.17 These representations from business point to a broad desire to see taxable profits and commercial profits move closer together and for all genuine business expenditure to be deductible for tax purposes.

1.18 Although it has been generally accepted that the accounting profits (as determined on a proper commercial basis) must be the starting point for computing trading profits for tax purposes, this approach has not been universally applied across the tax schedules. Furthermore, over time, court judgements and statutory rules have resulted in divergence between taxable and commercial profits. The changes to the taxation of intangible assets and financial instruments introduced in Budget 2002 are the latest in a series of progressive reforms over recent years that have reduced this divergence. However, a number of significant differences in treatment remain.

1.19 Some of the differences between tax and commercial profits exist for well-established policy reasons – for example, the disallowance of expenditure on entertaining and corrupt payments – and such policy-driven, specific disallowances would remain a feature of any modernised system.

I.20 However, in determining their commercial results, companies do not segregate the different sources of profit. And all genuine business expenditure is taken into account in arriving at overall profits. One of the advantages of recent changes has been to reduce the extent to which such genuine business expenditure is not allowable for tax purposes. But there are still significant "tax nothings" within the system.

NEXT STEPS

I.21 The Government has now decided to consult on further reforms and on the possible benefits that would arise from reducing differences in taxable and commercial measures of profit where appropriate.

ACCOUNTING CHANGES

I.22 Accounting itself has been evolving rapidly, and there will continue to be a steady stream of new standards. This process will be accentuated as a result of an EU requirement for all companies whose securities are traded on an EU regulated market to prepare their consolidated accounts in accordance with International Accounting Standards Board (IASB) standards. This will apply for accounting periods starting on or after 1 January 2005. The Department of Trade and Industry will be publishing a consultation document on the extent to which these standards should apply in the UK beyond the required minimum.

I.23 The Government recognises that, if there is radical change to accounting standards, this could affect their usefulness for tax purposes. This will be an issue whether or not there is further change because there is already considerable alignment between tax and accounts. Much of the concern has been focused on proposals for changes to accounting rules that are at a very early stage of development. The significance of the changes that are likely to emerge is, in any event, very uncertain at present.

I.24 If there are good policy reasons for doing so, the Government is prepared to temper the impact of particular accounting rules. For example, the new rules for intangible assets include reinvestment relief and the circumstances in which revaluations are taxed are very limited.

THE CURRENT PROPOSALS

I.25 The proposals set out in the remainder of this document would bring the computation of taxable profits more closely in line with that of the commercial results:

- Chapter 2 sets out the economic case for change;
- Chapter 3 sets out the possibilities for bringing the tax treatment of profits and losses on capital assets into line with their accounting treatment;
- Chapter 4 discusses the effect of the schedular system as it applies within the current regime and how it might be rationalised;
- Chapter 5 looks at the effect of the trading/investment distinction that features in many places in the existing regime. It considers whether this distinction remains appropriate in the modern business world; and
- Chapter 6 considers the interactions between the various proposals and invites views on their relative importance.

I.26 The proposals would, if implemented, represent very significant changes to the structure of corporation tax, whether taken individually or implemented together as a package. The Government is, therefore, keen to receive the comments of business and other interested parties on the proposals outlined in this document.

2 The Economic Case for Change

BACKGROUND

2.1 The Government's primary economic objectives are raising the underlying growth rate of the economy and maintaining high levels of employment. Investment, innovation, enterprise and risk-taking are key influences on these objectives. They may all be affected by the corporation tax regime, since it taxes the rewards from undertaking these activities.

2.2 The way in which profits are defined for tax purposes can have a range of economic effects. For example, it can:

- affect the choice between different types of saving and investment. This may adversely affect the efficiency with which the market allocates resources;
- create opportunities for tax avoidance if substantially similar types of income are taxed at different effective rates of tax; and
- affect the fairness of the tax regime if companies with similar profits do not pay similar amounts of tax.

2.3 These considerations point to having a regime that is neutral, so that differences in taxation do not distort significantly the pattern of investment. This suggests using as comprehensive a measure of taxable profits as possible.

2.4 In practical terms, this means that, as far as possible:

- definitions of what constitutes taxable profits should be aligned with those used for business or economic purposes, unless there are good policy reasons for a difference; and
- capital gains should be taxed in the same way as income. In particular, increases in value of an asset should be treated as part of taxable capacity, in essentially the same way as income accruals, and taxed at the same rates.

DEFINITIONS

2.5 The effects of differences in the definition of taxable profits are readily observed in the schedular system. In the commercial world the segregation of income sources imposed by the schedular system has little resonance. And there are inefficiencies inherent in a system that seeks to tax a profit defined in a significantly different way from that adopted by companies in measuring and reporting the profits they make.

2.6 This kind of difference is particularly noticeable in the way that the tax definitions separately identify trading and investment income. In economic terms there is little reason to distinguish between trading and investment activity. And while investment can be "passive", many businesses treated as investment companies for tax purposes are very "active", particularly those with large investment portfolios. Economic arguments suggest that there should be neutrality of treatment between the trading and investment activities of business.

THE RELATIVE TREATMENT OF INCOME AND GAINS

2.7 Similarly, there are good economic reasons for taxing all types of income and gains – however they have arisen – in the same way. Equal treatment promotes equity and discourages avoidance by converting one type of income into another.

2.8 In practice the valuation of capital – and hence the measurement of the economic profits or gains – can be difficult, especially where there is no readily ascertainable market price for an asset. Following accounting profits takes us part of the way towards a more comprehensive measure of profits. Box A sets out some of the detailed considerations involved in aligning the tax treatment of gains with the commercial accounts.

2.9 A further significant difference at present between the tax regime for capital gains and the accounts treatment is the indexation allowance which adjusts for inflation in computing capital gains. Commercial accounts are not inflation adjusted; they are generally prepared on an historic cost basis.

2.10 Inflation can have a number of potentially distortionary effects on the tax system (for example, reducing the real value of capital allowances and increasing the value of interest deductibility). However, systematically adjusting the tax regime so that the distortionary effects of inflation would be eliminated has never been judged practicable. It would anyway be second best to a macroeconomic regime which delivered low and stable inflation, with the wider economic benefits this brings.

2.11 The current regime in which only corporate gains are adjusted for inflation for tax purposes is likely to increase rather than reduce distortions - the deferral of taxation until realisation favours investment in assets which generate gains, and the indexation allowance reinforces this effect.

2.12 It is therefore the Government's view that following a company's commercial profits for tax purposes should reduce some of the distortions arising from the present regime. However, it is difficult to judge the relative empirical significance of each of these distortions and the Government would welcome business's assessment of their importance.

Box A: Aligning tax with commercial accounts

The definition of profits for tax purposes can have a significant impact on the neutrality of the tax system. The present tax code does not provide a general definition of income or profits. Tax liabilities arise when certain kinds of income (trading income and income from property, for example) are recognised in the accounts on an accruals basis, but in the case of capital gains and losses liabilities crystallise only on realisation. In a company's accounts, gains and losses are usually recognised only when realised or when they can be readily realised (in which case the assets are usually marked to market).

Taxing capital gains on realisation has a number of implications:

- **the value of tax deferral is greater the longer assets are held without being taxed, producing a "locking-in" effect; companies may be encouraged to hold on to existing assets even though their pre-tax return may be below that available elsewhere;**
- **tax payments are deferred until realisation and returns in effect roll-up on a pre-tax rather than post-tax basis; and**
- **the taxpayer has flexibility about when to realise a gain or a loss.**

Thus there is a case for taxing gains on a mark-to-market basis so as to be consistent with the accruals basis used for income. A counterpart to this would be to allow for amortisation and impairment to be given as they accrue, so that there is symmetrical income treatment of depreciation and appreciation.

However, there would be a number of practical difficulties in doing this for all assets. For example, a mark-to-market basis would require annual valuations and in some cases there might be no readily available market to enable current value to be ascertained. The practical answer might be to tax gains on a mark-to-market basis where this was the basis adopted in the company's accounts under the accounting standards applicable to that company's activities, but to tax gains on other assets on a realisation basis.

This raises the question of when deductions should be allowed for amortisation or impairment in computing taxable profits. Notwithstanding the asymmetric effects, the most practical approach is likely to involve relieving write-downs on an accruals basis, subject to recapture in the event of revaluation.

3 Taxation of Capital Assets

BACKGROUND

3.1 Recent changes, particularly to the taxation of transactions in intangible assets, corporate debt, derivatives and forex, have had the effect of taking some gains and losses out of the capital gains regime, where they have traditionally been dealt with, into an income regime. Budget 2002 also introduced an exemption for gains on a wide range of substantial shareholdings (broadly those of 10 per cent or above held by trading companies in other trading companies).

3.2 After these changes, the capital gains rules will apply only to a limited range of assets (referred to as "capital gains assets" in this chapter) owned by companies:

- land and buildings;
- those financial assets not within the derivative contracts or loan relationships regimes (including gains on shareholdings not within the new exemption); and
- tangible movable property (mainly plant and machinery) in the event of this being sold at a profit.

3.3 Chapter 2 concludes that there is an economic case for treating gains and losses on capital gains assets in the same way as income profits. This chapter considers how the remaining capital gains assets might be moved into an income regime and how relief might be given for the cost of purchasing these assets where appropriate.

GAINS INTO INCOME – HOW MIGHT A NEW REGIME WORK?

Application of a new regime

3.4 The details of any new regime for the treatment of capital assets within the scope of this document are for consideration and discussion. And, as discussed later, specific sectors, such as life insurance, need special consideration. But, subject to this, there is already a model from the legislation in Finance Act 2002 for intangible assets and the financial instruments legislation applying to derivatives and loan relationships. Between them, these offer the following broad framework:

- profits and losses would be taxed on the basis of the amounts recognised in the company's accounts (on a mark-to-market or realisations basis);
- companies would obtain relief for commercial depreciation on assets according to the amounts recognised in the company's accounts (subject to the comments on depreciation allowances below);
- where accounting standards do not require the gain on revaluation of an asset to be taken to the profit and loss account, the taxation of a revaluation gain would be deferred until the asset is disposed of. Any profit or loss on sale would be taxed or relieved as an income item at the time of realisation, including any intermediate revaluations. Except that, where a gain reverses

depreciation and impairments previously charged to the profit and loss account, the profit would be taxable at the time of revaluation;

- indexation relief would not be available in computing the profits on the disposal of assets; and
- rollover relief might be available in a similar manner to the relief available for intangible assets.

3.5 The Government sees a number of advantages for companies in an approach along the lines described above in that:

- the regime would maintain coherence with the intangible assets reforms and with the rules for derivative contracts and loan relationships which were developed through extensive consultation;
- companies would obtain relief for the cost of an asset as that cost is depreciated in the accounts;
- the profits and losses to be included in the corporation tax computation would be closer to the amounts of companies' commercial profits;
- companies would therefore no longer need to keep all the parallel records that are currently required for capital gains purposes; and
- annual tax computations and the completion of the CT 600 return would be easier for new companies starting to trade after the commencement day and increasingly for existing companies as the computation of their profits comes into line with the accounts.

3.6 Against that, special rules might be needed to deal with assets if they pass into or out of the unincorporated sector, particularly in those situations where the assets do not pass at current value under the existing rules.

The transition

3.7 The new regime offers significant benefits but in order to realise them it would be necessary to go through a transition which itself raises a number of issues. Again, the details of the transition are open to consideration and discussion. But if the models for intangible assets and financial instruments are followed, the main features of the transitional arrangements for moving to any new regime might be:

- there would be a cut-off point for the end of the old and the start of the new regimes – "the commencement day";
- assets acquired on or after the commencement day would be within the new regime, subject to what follows;
- assets acquired before the commencement day that were not included in the company's accounts on a mark-to-market basis would remain within the capital gains regime until they were first disposed of;
- for assets that were included in the accounts on a mark-to-market basis, any gain up to commencement day would be computed and held over until the subsequent disposal of the asset. Profits and losses would be recognised on a mark-to-market basis from the commencement of the new regime;

- for assets that remained within the capital gains regime, any losses on disposal would be available for set-off against other gains within the capital gains regime; and
- losses already crystallised within the capital gains regime would be available for set off against gains on assets that remained within the capital gains regime.

3.8 However, there are issues arising from such a transition:

- there could be a relatively long transition period for land and buildings during which time some companies might have to comply with both the capital gains rules and the new regime;
- there might therefore be an increase in companies' compliance costs in the short-term, although this would work its way out of the system as the number of assets subject to the pre-commencement rules diminished; and
- the implications for part-disposals and pooled assets would need careful consideration, as would the treatment of enhancement expenditure incurred post commencement on assets held at commencement.

3.9 In informal discussions since the Budget, some companies have suggested that they would be prepared to accept a shorter transitional period. It would be particularly helpful if respondents could address this possibility in their responses.

Rollover relief

3.10 The case for, and form of, any rollover relief would also need to be considered further. The relief provided within the new regime for intangible assets applies irrespective of whether those assets have been used for the purposes of a trade. This goes beyond the present rollover relief for business assets – that applies only to assets used for the purposes of a trade.

3.11 The Government sees no case for a rollover relief on income profits realised on the sale of shares. The case for a rollover relief for income profits on assets such as land and buildings, plant and machinery – where the proceeds of sale are reinvested – would need to be considered. Such a relief would introduce complexity by departing from the commercial profits. It would also mean that assets whose return is taxed only on realisation would continue to be favoured compared with those generating returns that are taxed on an accruals basis. On the other hand, it is argued that charging tax where the proceeds are wholly reinvested could cause cash flow difficulties for some companies. In framing the new regime it would be necessary to strike an appropriate balance between Exchequer yields, complexity and effects on investment.

WRITING DOWN THE VALUE OF ASSETS: RELIEF FOR DEPRECIATION

3.12 As noted in paragraph 3.4 above, one possibility is that companies would obtain relief for commercial depreciation or impairments according to the amounts recognised in the company's accounts. However, many assets already qualify for capital allowances.

3.13 This raises the question of whether it would be preferable to maintain the existing capital allowances system for some assets, with only those assets currently outside the capital allowances code being brought within a system of commercial depreciation.

3.14 There are some important issues in this area, and balances will need to be struck. The Government needs the input of business in order to arrive at the most appropriate outcome.

3.15 An important issue is the extent to which the existing capital allowances code offers a more or less beneficial treatment than commercial depreciation. This leads to questions about whether, and if so how far, the tax treatment should differ from commercial depreciation:

- there are a number of investment allowances that are specifically intended to provide a tax benefit when compared with commercial depreciation, for example the 100 per cent allowance for designated energy-saving technologies and 40 per cent first year allowance for small and medium-sized companies;
- the Government has already indicated that investment allowances are intended to be a permanent feature of the system. But the same or similar benefits might be delivered by alternative means;
- for some types of asset, the normal rates of capital allowances are not far out of line with rates of commercial depreciation. The allowances due on industrial and agricultural buildings are examples which fall within this category;
- in other cases, the use of fixed rate capital allowances can produce arbitrary effects. For example, commercial depreciation may be more or less generous than capital allowances, depending on the life of the asset; the benefit of capital allowances increases with the life of the asset; and
- for assets which do not qualify in full for capital allowances, commercial depreciation may well be beneficial. For example, the value of commercial depreciation on the whole of a commercial building may be greater than the value of capital allowances on only the plant and machinery element of that building.

3.16 Retaining capital allowances in a hybrid system might add to, rather than reduce, complexity. For example, some elements of a commercial building would continue to qualify for capital allowances, but the balance would qualify for commercial depreciation – and the apportionment made for capital allowance purposes would be unlikely to be the same as that made for accounting purposes.

3.17 The Government wishes to examine and discuss with business the case for moving wholly to a regime based on accounts depreciation (subject to the discussion above concerning investment allowances). Changing from a capital allowances regime to a depreciation regime would, of course, raise specific issues in different business sectors. These would need detailed consideration.

LEASED AND OTHER PARTICULAR TYPES OF ASSET

3.18 The proposals in this document would have significant implications for leased assets. There would also be special implications for particular assets such as long-life assets. The Government will want to consider the position of these types of asset and would welcome views on the issues raised.

LIFE INSURANCE COMPANIES

3.19 The Government recognises that life insurance companies need special consideration. A substantial proportion of life companies' profits accrues for the benefit of their policyholders and the tax paid on those profits is treated as discharging the liability (other than higher rate liability) of individual policyholders. So, for example, a treatment of gains appropriate to a company making profits only for its shareholders might be inappropriate for a life company, or at least require some modification. Once the way forward for companies generally is clear, the Government will consider whether measures arising might be applied to life companies. It will, of course, consult with the industry on any changes.

COLLECTIVE INVESTMENT SCHEMES

3.20 The position of collective investment schemes (OEICs and authorised unit trusts) that are dealt with under the corporation tax regime would also need to be considered carefully. The same is true for investment trusts and venture capital trusts. New rules would be needed to continue the tax exemptions for capital gains made by these vehicles.

CONTROLLED FOREIGN COMPANIES (CFCs)

3.21 Chargeable gains are currently excluded from the UK's CFC regime, unlike the position in most other countries that have such provisions. If gains were to be taxed as income, the natural consequence would be that these profits would then be within the scope of the CFC rules in a similar manner to their treatment in the new regime for intangible assets.

EXCHEQUER EFFECTS

3.22 The overall impact on the Exchequer of the proposed changes depends on the balance between those aspects of the proposals that would carry a cost to the Exchequer - for example, new depreciation relief for certain assets – and those that produce a yield for the Exchequer – for example, the abolition of indexation relief.

3.23 The Exchequer effects are also heavily dependent on behavioural effects. It would be helpful to discuss with business the practical impact of the reform to obtain a better understanding of the likely economic effects and Exchequer implications.

3.24 The detail of the transition to a new regime would also have Exchequer implications, which could have a significant bearing on the way that the changes could be introduced.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

3.25 The Government would welcome comments generally on the contents of this chapter, and specifically on the following points:

- *What would be the economic impact of moving the remaining capital gains assets into an income regime? What investment decisions might be affected by the reforms?*
- *Would moving the remaining capital gains assets into an income regime and taxing the profits accordingly, deliver real simplification benefits?*
- *Would it be necessary to introduce a rollover relief for gains on assets within an income regime? Is there any concern that a departure from the accounts for this purpose would introduce complexity?*
- *Would there be particular difficulties in relation to certain classes of asset, for example, pooled assets, or assets on which expenditure was incurred either side of a commencement day?*
- *What are respondents' views on the outline transitional arrangements and the length of any transitional period? Would a shorter and more certain transition period be preferable and how might this be achieved?*
- *What are respondents' views on the proposed treatment of the accumulated capital losses brought forward at the commencement day?*
- *Is it considered necessary to retain the existing capital allowances regime? If so, do the concerns with possible change relate to particular sectors or types of investment?*
- *Are there business sectors for which particular issues or difficulties are raised by these proposals?*
- *Are there significant issues for small and medium-sized companies in the proposals?*

4 RATIONALISATION OF THE SCHEDULAR SYSTEM

INTRODUCTION

4.1 The schedular system was created over 200 years ago and was based broadly on the commonly recognised forms of income at that time. In the intervening period the business and commercial environment has changed out of all recognition. Changes in the schedular system have not kept pace with the changing nature of business.

4.2 Consequently, the tax definitions of "income" now differ significantly from that of profits recognised by business. In the commercial world the segregation of income sources imposed by the schedular system has little resonance. In addition, the arguments for a more comprehensive measure of taxable profits (see Chapter 2) suggest that the various categories and sub-categories imposed by the schedular system are somewhat artificial.

4.3 There will sometimes be policy reasons why the Government would want the measure of profits for tax purposes to be different from the measure for business purposes. But, in the absence of such policy reasons, convergence is a desirable objective.

4.4 The principal impact of the schedular system on companies is on their ability to utilise losses. Potentially, it restricts the ability of a company to set off losses that have been generated on one type of activity against profits that arise from another. In some situations, the utilisation of losses may be deferred indefinitely if they become "trapped" within a particular schedule or case.

4.5 As discussed in Chapter 2, in principle there is an economic case for removing some, if not all, of the restrictions. The Government sees potential benefits in terms of simplification and compliance cost savings for companies. There is, however, no general intention to relax the present rules where companies with losses are bought and sold.

4.6 Reform of the schedular system might therefore address:

- the different rules for computing the profits chargeable under Schedule D Case I, Schedule A and the investment income of both trading and investment companies. (The issues around the tax system's differential treatment of trading and investment companies are discussed further in Chapter 5); and
- the streaming of losses carried forward that limits their use so that they are available to set off ***only*** against similar profits. For some companies, with only one main source of income, the streaming of losses may not have any significant effect. However, for the many companies with multiple sources taxed under various schedules or cases the effects may be significant.

INTERNATIONAL COMPARISON

4.7 It has been suggested that the UK's schedular system, with its separate heads of charge, is out of step internationally. Annex A sets out details of the relevant features of the regimes of a number of the UK's main trading partners. Generally these regimes have systems in which all types of profits are aggregated into a single pool of business profits and taxed under a single head of charge.

4.8 A more detailed analysis of overseas regimes, however, suggests that in terms of the practical outcome the differences between those systems and the UK system may not be very great. For example, while there is commonly a single pool of business profits, generally there are separate, complex rules for calculating the individual categories of income before their aggregation into the pool.

4.9 In relation to losses, the regimes of other countries all have restrictions to a greater or a lesser degree on the use of losses carried forward or carried back. Some impose a limit on the number of years over which the losses can be used.

4.10 In addition, most of them require both the separate calculation of capital gains and the streaming of capital losses carried forward.

COST IMPLICATIONS

4.11 Before considering the ways in which the rules of the schedular system might be rationalised it is necessary to give some thought to the potential practical limits to rationalisation. A key factor is the Exchequer effect.

4.12 The cost to the Exchequer of rationalising the schedular system would arise from:

- companies being able to obtain relief for their losses more quickly; and
- companies being able to obtain relief for losses that would otherwise not be relieved under the current rules.

4.13 The rate at which companies might consume losses in any rationalised regime in future, together with any consequential behavioural changes, are significant factors in assessing the costs of any changes. The latter, particularly, makes costing difficult. Consequently, the Government wishes to engage with business in order to gain a deeper understanding of the likely effects.

QUANTUM OF LOSSES IN EXISTING SYSTEM

4.14 An analysis of Inland Revenue data has produced the following overall picture of existing losses:

- the total aggregate "income" losses brought forward by the corporate sector at 31 March 1999 are estimated to be in excess of £70 billion. The majority of these are losses that have arisen under Schedule D Cases I and III;
- in the year to 31 March 2000, companies generated total losses of around £65 billion of which around £15 billion (mainly Schedule D Cases I and III) were unutilised and carried forward to later accounting periods; and
- the provisional data for the year ended 31 March 2001 show total losses generated of around £80 billion of which around £15 billion to £17 billion (again, mainly Schedule D Cases I and III) are likely to be unutilised and available for carry forward to later accounting periods.

APPROACHES TO RATIONALISATION

4.15 A minimalist approach would be to rationalise rules for computing profits or losses under the various schedules while retaining the existing loss relief rules. For example, it might be possible to align more closely, or perhaps completely, the rules for the computation of profits arising under Schedule D Case I and Schedule A. Perhaps also the computation of the investment income of trading companies and the profits of investment companies could be aligned with the computation of trading profits (again, see Chapter 5).

4.16 At the other end of the spectrum would be complete abandonment of the schedular structure. Profits falling within the Cases of Schedule D (I, III, V and VI) and under Schedule A (after deducting any management expenses) would be brought together into a "business profits" pool under a single head of charge with any losses capable of being offset immediately or carried forward or back as appropriate.

4.17 In between these extremes, there are various intermediate positions, for example bringing together profits and losses of:

- all trades, but leaving all other sources taxed under the existing rules; or
- all trades and income from property, but leaving all other sources under the existing rules; or
- all trades, profits arising under Schedule D Cases V and VI, and income from property but keeping Schedule D Case III separate.

4.18 Another method of determining the separate pools of business profits might be to consider whether profits arose from either a "passive" or "active" business. This is an approach that is adopted by a number of other countries, including the USA and the Netherlands. For example, the US system treats losses generated by limited partnership investments or rental real estate as "passive" and they may be set off only against net passive income in future years.

4.19 All these options need to be considered in the context of potential economic benefits, the priorities of companies and affordability.

4.20 Complete abolition may be ruled out on grounds of cost. The Government wants to identify the intermediate options that could deliver the greatest economic benefits and simplicity within Exchequer constraints. In formulating comments on the various options, it would be helpful if respondents could identify which intermediate options or approaches seem to make best commercial sense either in the context of their own business or on a broader analysis. In addition, if such reform has to be achieved in stages, it would be particularly helpful to have views on which steps should have priority.

CAPITAL GAINS

4.21 Chapter 3 considered whether the remaining capital gains assets should be taxed within an income regime. If so, then as long as the schedular system was unchanged, or rationalisation extended only to the closer alignment of the detailed computational rules, it would be necessary to allocate the gains to schedules and/or cases, as has been done for loan relationships and intangible assets. For example:

- gains on assets that were held for the purposes of a trade could be taxed as income under Schedule D Case I;

- gains that accrued to a property investment company could be taxed under Schedule A;
- gains that accrued from financial assets could be brought into account as credits under the loan relationships legislation and included in Schedule D Case III profit; and
- gains that did not conveniently fall under any other schedule or case of Schedule D could be taxed under Schedule D, Case VI.

4.22 Doing this would follow the general pattern adopted for changes to the corporate tax regime in recent years.

4.23 At the other extreme, if it were possible to abandon the schedular structure completely, it would then be necessary to consider whether future profits and losses arising on former capital gains assets should be:

- freely available against all other income profits and losses – in effect becoming part of the single pool of business profits (unlike the regimes of most other countries where capital losses can be set off only against gains); or
- regarded as a separate "income" pool with any losses carried forward being streamed only against similar profits in future accounting periods; or
- part of one of the more limited income pools if the schedular system is rationalised in one of the ways suggested in paragraph 4.17, rather than abolished.

OTHER ISSUES

4.24 Some of the factors that determine how much the changes would cost have already been discussed. Another very significant cost issue is the treatment of the accumulated income losses that would exist at the commencement date of the new regime – see paragraph 4.14. Clearly, freeing up the use of these losses within a rationalised schedular regime could have a very significant Exchequer cost. Consequently, it would be necessary either to continue to apply the current regime to those losses or devise a form of "shadow" loss regime. Alternatively looking to the controls used by other countries, another approach might be to stream the losses carried forward or limit their availability to a fixed time period

4.25 In relation to other losses, it would be important to consider which elements of the current anti-avoidance legislation it might be necessary to retain, for example, in relation to loss-buying. It might also be necessary to consider some additional controls. These could include some new and limited forms of loss streaming. The Government would be interested in receiving views as to what other forms of controls or mechanisms might be acceptable in such circumstances.

4.26 Another issue that would need careful consideration is whether rationalising the schedular structure would increase any distortions in the tax system or introduce new distortions. In particular, it would be necessary to consider the distributional and competitive effects of any changes. These might result in some companies being able to increase their consumption of losses unfairly compared with those who cannot get immediate relief for all of their losses under the current rules, and who might not benefit or benefit to the same extent as a result of any rationalisation.

4.27 The implications of any rationalisation of the schedular system for North Sea companies will need to be considered when the position for companies generally is clearer. But it is not intended to dismantle the current North Sea oil ring fence as part of these changes.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

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

- ***What are respondents' views on the present schedular system? Which particular aspects cause problems? Please elaborate on the nature of any such problems, for instance, how are investment decisions affected?***
- ***Of the options identified in this chapter, which would be most useful and deliver most economic benefits and greatest simplification? In particular, regard should be had to the possibility that the more expansive options might not be affordable, at least in a single step.***
- ***Are there any other options for reform which have not been identified in this chapter?***
- ***How should the accumulated income losses at commencement day be treated?***
- ***If affordability were an issue, what might be acceptable ways of limiting the potential cost to the Exchequer?***

5 The Treatment of Trading and Investment Companies

INTRODUCTION

5.1 As well as differentiating between different sources of profit, the tax regime also differentiates between different types of business. This differentiation affects the way that corporate profits are computed and taxed and the reliefs available to shareholders in those businesses.

5.2 Many of the differences go back a long way. The effects of some have developed unintentionally, others by design. At the most basic level, although the broad intent of the expenditure rules is the same, their application results in some very real and material differences in practice. For example:

- deductions of trading companies are based on the expenses shown in the accounts – subject to statutory prohibitions;
- deductions for investment companies are statutorily prescribed, instead of being based on the accounts; and
- the difference in the rules can result in differences in the timing of recognition of expenses for tax purposes.

5.3 In addition, there are statutory provisions that, as a result of policy design, give trading companies more favourable treatment than investment companies. For example, capital gains rollover relief is available only for disposals of certain trading assets and favours trading companies over investment companies.

5.4 The effect of differences in treatment are not all one way. For example, the rules for the carry-forward and set-off of surplus management expenses and Schedule A losses (which may be set-off against any future profits) are more generous than those for trading losses (which may only be set-off against future trading profits).

5.5 Many reliefs available to shareholders are available only in respect of holdings of shares in a trading company. Thus, the new exemption available for substantial shareholdings is available only for shares in a trading company or group held by a trading company or a member of a trading group. Capital gains tax taper relief for company assets in the form of shares depends significantly on whether the shares are held in a trading company.

5.6 Historically, some of the differences were justified on the grounds that trading activity was more important to the UK economy; the rationale was that trading activity and manufacturing were more likely to create employment and demand for UK goods and services than investment activity. Similarly, there was a presumption that investment activity is "passive", whereas trading is "active". But the structure of the economy and businesses operating within it have changed radically.

5.7 Moreover, companies and groups undertake a variety of activities and the simplistic division between trading and investment no longer holds, creating particular practical problems for companies which change character and shift from one category to the other.

5.8 Similar difficulties arise for companies that fall into neither one category nor the other. For example, a company that carries on a trade might also carry on an investment activity or act as the holding company of a group or a sub-group and might not therefore qualify as either a trading company or an investment company. The failure of tax legislation clearly to cater for these hybrids has been the subject of representations over a long period.

Box B: Implications of differences

Distinctions based on the type of activity undertaken by a company have been drawn in many places in the UK tax system, in some cases because tax measures have been targeted on particular activity or classes of company for wider policy reasons or as defence against avoidance. Significant differences arise in:

- **Deductibility of expenditure**
- **The set-off of losses**
- **Company reconstruction legislation**
- **Exit charge on chargeable assets**
- **Exemption for gains on substantial shareholdings**
- **Rollover relief**
- **Demergers legislation**
- **Purchase of own shares provisions**
- **Enterprise reliefs (CVS, EIS, VCTs)**
- **Hold-over relief**
- **Loss relief to shareholders and lenders**
- **Business assets taper relief**

See Annex B for further detail

5.9 While this suggests that the historic case for a general trading/investment divide no longer applies, simple removal of the boundary would not necessarily result in a "fair", "effective," regime. For example, it might open up opportunities for individuals to obtain favourable treatment for personal investments if the distinction between trading and investment companies were abandoned completely.

5.10 Further, in many cases, investments held by a company will come into charge to tax only on realisation, whereas the accruals basis applies to much if not all of the activities of a trading company. An investment company may therefore be better placed to exercise a degree of choice as to when profits or losses are realised.

5.11 The Government believes that while some distinctions may remain justified, it is for consideration whether the current boundary and distinctions between the treatment of trading and investment at both corporate and shareholder level remain appropriate, or whether changes would better match Government policy and modern business activity.

OPTIONS FOR CHANGE

5.12 As a minimum, the tax rules for computing profits and the deductibility of expenses might be more closely aligned with accounting rules. Rationalisation of the schedular system as set out in Chapter 4 would in any event go a long way to achieving this objective.

5.13 At the other extreme, it might be possible to make changes to the boundaries generally, subject to considering the policy rationale for the present boundary in each of the discrete situations and varying the effect of the general change where appropriate.

5.14 In between, it might be possible to adopt an intermediate pragmatic approach so as:

- to distinguish the treatment of "active" investment companies from "passive" investment companies and treat the former in the same way as trading companies, subject to protection against exploitation;

- to extend some of the reliefs currently available only to trading companies to investment companies; or
- to treat an investment company which is in substance an adjunct to, or an integral part of, a group's trading activities, as though it were itself carrying on a trade.

EXCHEQUER COSTS

5.15 The Exchequer effects would depend upon the precise changes. Exchequer effects could be managed as necessary through phased implementation of any changes taking account of business priorities.

5.16 More specifically the scope for exploitation will have to be carefully considered before the boundary between trading and investment could be moved. For example, the scope for "enveloping" individual properties within single companies, primarily for tax reasons, will be a significant factor in determining the shape of any reform applying to the property sector.

5.17 In any event, it is likely to be necessary to continue to provide Exchequer protection against the erosion of the personal tax base by the use of corporate wrappers. At the very least this is likely to mean retaining separate rules for personal investment companies.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

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

- ***What are the practical effects of the existing boundaries (both at corporate and shareholder levels) between trading and investment companies?***
- ***In particular, what problems do the current boundaries and rules cause? How are business decisions, including choice of investment, affected?***
- ***If the current boundaries are considered to be no longer appropriate how should these be changed and why?***
- ***Do views on where the boundaries should be moved differ according to the relief, or other situation, being considered?***
- ***As regards the detailed computation of profits, how might any alignment of the rules be best achieved?***

6 CONCLUSION

6.1 The Government's principles that guide further reforms to the corporate tax system are those set out in the July 2001 consultative document. The Government is creating a regime that is modern and competitive and reflects the realities of the business environment. This document seeks the views of business and other interested parties on three potential further reforms:

- the tax treatment of capital assets not covered by earlier reforms;
- rationalisation of the schedular system; and
- the differences in the tax treatment of trading and investment companies.

ORDER OF MAKING ANY CHANGES

6.2 Following the recent Budget changes in respect of derivatives contracts, loan relationships and intangible assets, the most logical next step might be to take the remaining capital gains assets into an income regime. While this step could be taken on its own and on its own merits, such a change would raise issues that are also present in consideration of the other two proposals. For example, if the remaining capital gains assets are to be moved into an income regime, questions are raised as to which schedules and cases they should be allocated and the rationale for doing this.

6.3 The distinctions made by the schedular system reflect the current differences in the tax treatment of trading and investment companies. So, if it is necessary to rationalise the schedular system, can this be done without, at the same time, examining the rationale for the current differences in the treatment of trading and investment companies?

6.4 As so many of the issues cut across all three proposals, there is a good case in principle for taking forward all the changes at the same time. However, there are a number of reasons, many of them practical which might make that difficult. Such a change would involve a very large amount of legislation. And the Exchequer implications might necessitate a phased introduction of the reforms.

6.5 The Government would therefore welcome respondents' views as to:

- the relative importance that they attach to each proposal; and
- the order in which the changes should be made if it is not possible to introduce them all at the same time.

OTHER ISSUES

6.6 Rationalising the schedular system would be a logical step in its own right in the taxation of a single company: the focus of this consultation document is at company level. But the Government recognises that this issue also raises questions about the taxation of groups of companies. In the informal discussions that have taken place with business and the professions since the Budget 2002, some see rationalisation of the schedular system as a useful step towards the taxation of groups on a consolidated basis. Others have expressed the view that taxing groups on a consolidated basis would not be desirable and that similar advantages and flexibility might better be achieved by rationalising the rules for group relief.

6.7 The Government would welcome further comments on these points. Even if taxing groups on a consolidated basis were seen as a useful reform, there is a working presumption that it should be contemplated subsequent to the reforms discussed in this consultative document.

POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS

6.8 As well as comments on the detailed questions set out in previous chapters, the Government would welcome comments on the following more general points:

- ***What do respondents see as the relative priorities of the three proposals for reform set out in this document? How would investment and other business decisions be affected by different options?***
- ***Would real simplification result from each of the proposals?***
- ***What compliance cost savings can be identified?***
- ***Are there any aspects of any of the proposals that raise particular issues for different sized companies?***
- ***Are there any particular types of business that might be affected differently or need special consideration?***
- ***Do respondents agree that considering the taxation of groups on a consolidated basis would be a subsequent step to the present proposals?***
- ***Are there any other issues that the Government should consider as part of this review?***

A Treatment of Business Profits & Losses in Other Countries

INTRODUCTION

A.1 Generally, tax systems adopt either a global or schedular approach to taxation. The global system generally taxes income from whatever source whilst the schedular system focuses on categories and has different rates and computations for these separate classes.

A.2 In practice however, the two systems have many overlapping elements and there is often schedular categorisation within global systems. There are, for example, particular activities or deductions that are given special treatment and cannot be set against other items of income. The treatment of losses is a good illustration of this schedular aspect where even global systems adopt timing or streaming restrictions.

A.3 The following international comparisons highlight that whilst global systems are adopted there are often schedular restrictions.

UNITED STATES

Profits **A.4** The US does not have a schedular system of taxation. Corporations are taxed on all income of whatever type and from whatever source derived, including capital gains. The same rates of tax apply to all types of income.

Losses **A.5** For losses incurred in taxable years beginning on or before 5 August 1997, the carry-back period is 3 years and the carry-forward period is 15 years. For losses incurred in taxable years beginning after 5 August 1997, the carry-back period is 2 years and the carry-forward period is 20 years.

A.6 In the event of a change in corporate ownership, the deduction of losses is limited. An ownership change is deemed to occur if there is a change in the stock ownership of the corporation or an equity structure shift (i.e. a merger or reorganisation) that, generally described, results in a 50 per cent change in the ownership of the corporation relative to the ownership during the prior 3-year period. In that event, the amount of carry forward loss that may be deducted in each future year is limited to the value of the corporation immediately before the ownership change multiplied by the long-term tax-exempt rate of interest published by the IRS for the month of the ownership change.

A.7 Capital losses of corporations may be deducted only against capital gains. Unused capital losses may be carried back 3 years and forward 5 years and used to offset capital gains in such years.

FRANCE

Profits **A.8** All types of business income are taxed under one category. Corporate tax is levied on the aggregate net income from various sources of business income, including capital gains arising on the transfer of business assets.

Losses **A.9** Losses are deductible from taxable income in the year they are incurred. Losses that cannot be absorbed by current income may be carried forward for 5 years or back for 3 years. The 3 year carry back does not result in an immediate refund of corporate income tax paid in earlier years but rather in a credit that can be used to pay the corporate income tax due over the following 5 years. The balance is refunded during the sixth year. The credit can also be discounted with a bank.

A.10 France has a specific long and short-term capital loss regime. For non-depreciable assets, a loss is long-term if the asset was acquired or created at least two years before disposal, and short-term if created or acquired less than two years before disposal. Losses on depreciable assets held for more than two years are always treated as short-term losses. If short-term losses exceed short-term gains, the net short-term capital loss is deductible from the ordinary income of the financial year. Any remaining net short-term loss can be carried over as an ordinary operation loss. During the normal life of a company, net long-term losses can only be used to set off long-term gains. The net long-term capital losses may be carried forward for ten years.

A.11 In principle, losses carried forward must be set off against the first available positive income. However, the tax authorities accept the spreading of a loss in one-year carry-forward against the income of the following 5-year period: if that would allow the company to distribute a dividend without the need to pay the *précompte* (a form of equalisation tax). An election for spreading is at the risk of the taxpayer (e.g. future profits may not be sufficient to absorb the loss carry-forward).

Restrictions on loss carry forwards **A.12** On a merger, division or similar restructuring, the pre-merger losses of the absorbed company are lost, unless their (full or, more often, partial) transfer to the absorbing company is authorised by the Ministry of Finance. The pre-merger losses can also be used to offset long-term capital gains on the assets transferred so that such gains are not later taxed in the hands of the absorbing company. However, as a result of the cancellation of the long-term capital gains tax regime for most assets, this measure has lost most of its relevance.

A.13 A company which ceases to be subject to corporate income tax (e.g. option to be treated as, or transformation into a partnership) loses the right to any carry-forward of previous losses (whether ordinary or other). A modification of the real activities is not deemed to be a cessation of an enterprise (and thus does not affect the carry- forward), unless it is very substantial.

A.14 The transformation of the legal form of a company into another legal form is not deemed to be a cessation of an enterprise (and thus does not affect the loss carry-forward) unless such transformation is deemed to give rise to a new legal entity. Under the Civil Code, a transformation does not normally result in the creation of a new legal entity unless, for example, a company is transformed into an association or a grouping.

A.15 Capital losses on items that qualify for the long-term capital gains regime (see A.10) can only be credited against long-term capital gains of the following 10 years. Capital losses that do not so qualify are treated as ordinary operating losses. Until recently long-term capital gains were subject to a reduced corporate income tax rate, therefore a distinction between short-term and long-term gains was essential. It is now less relevant since the application of the reduced rate has been significantly restricted and most capital gains are treated as ordinary income.

A.16 There are restrictions on the carry forward of capital losses where companies are restructured or transformed.

GERMANY

Profits **A.17** For a long time Germany applied a full imputation system and different corporate tax rates for distributed and retained earnings. That system was abolished by the Tax Reduction Law approved on 14 July 2000 and a single tax rate applies as from that year for companies that have a financial year corresponding to the calendar year and the subsequent year for all other companies.

A.18 The Tax Reduction Law also abolished the classification of taxable income into different "baskets". All income of a company (including, in general, capital gains) is categorised as business income and liable to corporate income tax accordingly. There are transitional rules, lasting 15 years, for the treatment of profits earned under the old system.

Losses **A.19** Unrelieved losses of one year may be carried forward. Losses up to an amount of €500,000 may be set off against the profit of the year preceding the year in which they were incurred. For losses in excess of €500,000 an indefinite and unlimited carry-forward is granted. A company may request to carry forward losses rather than carry them back.

A.20 A company is not allowed to carry over losses if (i) more than 50 per cent of the shares of the company are transferred and (ii) the business of the company is then continued or resumed with more than 50 per cent new business assets.

A.21 Capital losses suffered on the disposal of company assets constitute ordinary losses, which are normally deductible as "other" company expenses.

A.22 As from 2002 a company may no longer deduct capital losses arising from the sale of shares in resident companies. This does not apply to short-term losses realised by banks and financial institutions from sales of their commercial portfolio holdings.

JAPAN

Profits **A.23** Corporations in Japan are taxed on the aggregate of their income from all sources. This includes capital gains, except gains derived from land or buildings that are taxed separately.

Losses **A.24** In Japan, there are two types of corporate tax returns - blue and white. A blue tax return is used when a company is filing a statement of establishment of a domestic corporation or a statement of establishment of a foreign corporation.

A.25 In general, a company permitted to use a blue form tax return may carry back tax losses for one year or carry forward losses for five years for corporation tax purposes.

A.26 However, the one-year loss carry-back rule has been temporarily suspended; losses incurred during fiscal years ending after 31 March 1992 and before 31 March 2002 cannot be carried back.

A.27 In general a taxpayer returning a white tax return may not carry losses forward or back with the exception of losses in respect of inventories or fixed assets arising from natural or human disaster which may be carried forward for 5 years.

A.28 Capital losses can be offset against income from other sources.

THE NETHERLANDS

Profits **A.29** Corporate tax is assessed on the aggregate of profits derived by an enterprise (under whatever name and in whatever form). No distinction is made between ordinary income and capital gains; both are taxed at the standard corporate tax rates.

Losses **A.30** An ordinary loss arises when the deductible expenses exceed the gross taxable profits of a company in a fiscal year. The accounting losses appearing in the company's balance sheet do not always constitute tax losses because certain expenses are not deductible for tax purposes. Ordinary losses include initial losses and terminal losses.

A.31 Losses may be carried back and forward. Losses sustained in any fiscal year may be carried back to the 3 preceding years and forward indefinitely. Losses must be set off in the sequence in which they are incurred and against profits in the order realised.

A.32 In general, the carry forward of losses against future profits is denied if the beneficial owners of the future profits have mainly (i.e. 70 per cent or more) changed. (Although in certain circumstances the loss carry forward remains available).

B Differences Between Trading and Investment Companies

DIFFERENCES AT THE CORPORATE LEVEL

Deductions

B.1 A company that carries on a trade is entitled to deductions from income based on the amounts arising under generally accepted accounting principles subject to statutory prohibitions - most notably those in S74 ICTA 1988.

B.2 Relief for non-trade expenses is available against non-trade sources. Case III deficits can be relieved against profits of any description. In the case of investment companies, relief is available for management expenses (given in S75 ICTA 1988).

Losses

B.3 A company may offset trading losses against any profits of the same accounting period or of the preceding twelve months. Any unused losses can then be carried forward and be set against future profits of the same trade.

B.4 Losses arising from some non-trading activities can be set off in-year against all profits. Case III deficits may also be carried back but only against other loan relationship profits of the previous 12 month period.

B.5 All types of loss can be carried forward against profits from the same source. Case III deficits can be carried forward against any non-trading profits of later periods. Carried forward Schedule A losses and excess management expenses carried forward may also be set off against profits of any description.

Close investment holding companies

B.6 Restrictions apply to certain non-trading companies. They are not eligible for the lower rates of corporation tax.

Company reconstructions

B.7 Under S343 ICTA 1988, where a trade or part of a trade is transferred between two companies under common ownership, then, subject to certain conditions, a continuation basis is used. This means that trading losses are transferred and capital allowance written-down values are transferred without adjustment.

B.8 There is no similar provision for non-trading companies.

Exit charge

B.9 Where a company emigrates from the UK, there is a deemed disposal (for capital gains purposes) of all assets held. However, where any assets remain in the UK to be used in a trade that continues to be carried on by an UK branch or agency, then the charge is deferred.

B.10 There is no equivalent provision for deferring gains on non-trading assets.

Substantial shareholdings

B.11 The relief introduced in Finance Act 2002 applies to a disposal of a substantial shareholding in a trading company, or the holding company of a trading group, but not otherwise to a disposal of a substantial shareholding in a non-trading company. See also B.18.

Rollover relief

B.12 Where qualifying assets used in a trade are disposed of, and the proceeds reinvested in other qualifying trade assets, any gain may be rolled-over into the new asset.

B.13 This relief is not generally available to non-trading activities, with a few exceptions such as commercial woodlands and furnished holiday lettings.

DIFFERENCES AT THE INVESTOR/SHAREHOLDER LEVEL

Demergers

B.14 Where a single trading company or the holding company of a trading group is being de-merged any distribution is exempt, subject to conditions being satisfied.

B.15 There is no equivalent treatment for non-trading companies, except where they are holding companies of a trading group.

Purchase of own shares

B.16 In certain circumstances, where unquoted trading companies (and unquoted holding companies of trading groups) buy back issued share capital at a premium, that premium will not be treated as an income distribution.

B.17 There is no equivalent relief for non-trading companies.

Substantial shareholdings

B.18 The Substantial Shareholdings provisions introduced in Finance Act 2002 provide for the exemption of gains on the disposal of substantial shareholdings by trading companies or non-trading companies that are members of trading groups.

B.19 The relief does not otherwise extend to disposals by non-trading companies.

Enterprise reliefs (CVS, EIS, VCTs)

B.20 The tax reliefs under these schemes are available only for investment in smaller companies carrying on certain trades. For CVS, the investor must not be an investment company or be carrying on a non-financial trade.

Close investment holding companies

B.21 Relief for interest on loans to buy shares in, or lend money to, a close company will not be available if the company is a close investment holding company

Hold-over relief

B.22 The capital gain arising to an individual or certain trustees on the disposal of trading assets or shares in an eligible trading company may be held over to the extent that the asset is gifted. This is extended to companies in the business of occupation of woodlands.

Loss relief to shareholders and lenders

B.23 Persons who have lent money or guaranteed loans to certain trading companies may be entitled to relief for any capital losses incurred on the loan or guarantee.

Business assets taper relief

B.24 Gains on the disposal of by individuals and others of shares in a trading company, or the holding company of a trading group, can (subject to certain conditions) benefit from an accelerated rate of taper relief.

B.25 This accelerated rate is also available on shares in non-trading companies, but only when held and disposed of by eligible employees of the company.

C

Summary of Consultation Points

Question	Point of Consultation	Paragraph
1	What would be the economic impact of moving the remaining capital gains assets into an income regime? What investment decisions might be affected by the reforms?	3.25
2	Would moving the remaining capital gains assets into an income regime and taxing the profits accordingly, deliver real simplification benefits?	3.25
3	Would it be necessary to introduce a rollover relief for gains on assets within an income regime? Is there any concern that a departure from the accounts for this purpose would introduce complexity?	3.25
4	Would there be particular difficulties in relation to certain classes of asset, for example, pooled assets, or assets on which expenditure was incurred either side of a commencement day?	3.25
5	What are respondent’s views on the outline transitional arrangements and the length of any transitional period? Would a shorter and more certain transition period be preferable and how might this be achieved?	3.25
6	What are respondents’ views on the proposed treatment of the accumulated capital losses brought forward at the commencement day?	3.25
7	Is it considered necessary to retain the existing capital allowances regime? If so, do the concerns with possible change relate to particular sectors or types of investment?	3.25
8	Are there business sectors for which particular issues or difficulties are raised by these proposals?	3.25
9	Are there significant issues for small and medium-sized companies in the proposals?	3.25
10	What are respondents' views on the present schedular system? Which particular aspects cause problems? Please elaborate on the nature of any such problems, for instance, how are investment decisions affected?	4.28
11	Of the options identified in this chapter, which would be most useful and deliver most economic benefits and greatest simplification? In particular, regard should be had to the possibility that the more expansive options might not be affordable, at least in a single step.	4.28
12	Are there any other options for reform which have not been identified in this chapter?	4.28
13	How should the accumulated income losses at commencement day be treated?	4.28
14	If affordability were an issue, what might be acceptable ways of limiting the potential cost to the Exchequer?	4.28
15	What are the practical effects of the existing boundaries (both at corporate and shareholder levels) between trading and investment companies?	5.18

16	In particular, what problems do the current boundaries and rules cause? How are business decisions, including choice of investment, affected?	5.18
17	If the current boundaries are considered to be no longer appropriate how should these be changed and why?	5.18
18	Do views on where the boundary should be moved differ according to the relief, or other situation, being considered?	5.18
19	As regards the detailed computation of profits, how best might any alignment of the rules be achieved?	5.18
20	What do respondents see as the relative priorities of the three proposals for reform set out in this document? How would investment and other business decisions be affected by different options?	6.8
21	Would real simplification result from each of the proposals?	6.8
22	What compliance cost savings can be identified?	6.8
23	Are there any aspects of any of the proposals that raise particular issues for different sized companies?	6.8
24	Are there any particular types of business that might be affected differently or need special consideration?	6.8
25	Do respondents agree that considering the taxation of groups on a consolidated basis would be a subsequent step to the present proposals?	6.8
26	Are there any other issues that the Government should consider as part of this review?	6.8

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About the Consultation Process

CODE OF PRACTICE ON WRITTEN CONSULATION

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.

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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