HM TREASURY

HM Revenue & Customs

Simplification review:

capital gains rules for groups of companies – a discussion document

July 2009

ISBN 978-1-84532-604-3
PU796

Basic information

Subject of this consultation:	The policy options in this discussion document are aimed at simplifying the legislation on capital gains for groups of companies.
Scope of this consultation:	This discussion document deals with policy options to simplify some of the legislation on capital losses after a change in ownership, legislation on value shifting and depreciatory transactions, and legislation on degrouping.
Impact Assessment:	There is no Impact Assessment for the policy options at this stage. Responses received to the questions on compliance burdens and wider impacts in Chapter 6 of this discussion document will assist the Government in producing an Impact Assessment in future, if more detailed proposals are developed.
Who should read this:	The Government would like to hear the views of business, as well as the views of representative bodies and tax advisers, on the options outlined in this discussion document, in order to develop more detailed proposals.
Duration:	The consultation period for this discussion document runs from 7 July 2009 to 30 September 2009.
Responses and enquiries:	Responses and enquiries should be sent to: The Related Companies Simplification Review Team Room 2/E1 HM Treasury 1 Horse Guards Road London, SW1A 2HQ Alternatively, please email: relatedcompanies.simplification@hm-treasury.x.gsi.gov.uk Telephone enquiries: 020 7270 6104
Additional ways to become involved:	The Government intends to hold workshops to discuss stakeholder views and any further ideas in September 2009. Please send your expressions of interest to the e-mail address above and indicate your preferred dates by 31 July 2009.
After the consultation:	The answers the Government receives to these questions will assist in the development of more detailed proposals, expected to be published in a future full consultation document by the end of 2009, with a view to bringing forward clauses for legislating at the earliest opportunity.
Getting to this stage:	Since initiating an online survey on the corporation tax rules for related companies at the 2007 Pre-Budget Report, the Government has been listening to the views of business through productive dialogue with a number of representative bodies. The aim of these initial discussions has been to identify specific rules within the capital gains legislation (as it applies to groups) that would benefit most from simplification, and to develop workable proposals for simplifying these rules.

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1 Introduction

1.1 In the 2007 Pre-Budget Report, the Government renewed its commitment to tax simplification, launching three reviews to evaluate how a range of tax policies could be simplified. The simplification reviews cover VAT, anti-avoidance legislation and the corporation tax (CT) rules for related companies. This discussion document arises out of the related companies simplification review.

1.2 HM Treasury and HMRC continue to work in partnership with business on the three reviews, with the aim of creating simpler yet effective tax rules, which should in turn enhance UK competitiveness. The Government is determined to ensure that the UK provides a world-class environment for business, and recognises that the simplicity of the tax system is an important factor in a country's international competitiveness.

1.3 The Government is committed to ensuring that simplification is a priority when designing and reviewing tax legislation, alongside sound public finances and promoting fairness. In the context of corporate taxation, the focus on fairness includes ensuring that companies receiving the same economic returns bear the same amount of tax, to the extent this can be achieved consistently with other objectives.

Related companies simplification review

1.4 At the 2007 Pre-Budget Report, the Government initiated an online survey on the corporation tax rules for related companies, to identify which areas of these rules were leading candidates for simplification. Well over 100 responses were received from a range of interested parties including professional advisers and representative groups. Shortly after this, the Government issued an update on the review of corporation tax rules for related companies, outlining four areas identified as having potential for review. Of these, there were two immediate priorities for simplification: the associated companies rules as they apply to the small companies' rate of CT, and the capital gains rules as they apply to groups of companies. This discussion document concerns the capital gains rules for groups.

1.5 The Government has been listening to the views of business, through productive dialogue with a number of representative bodies. The aim of these initial discussions has been to identify specific rules within the capital gains legislation (as it applies to groups) that would benefit most from simplification, and to develop workable proposals for simplifying these rules.

Summary of proposals and consultation process

1.6 The initial dialogue with representative bodies has assisted the Government in developing a package of proposals to simplify the capital gains rules for groups in the following three areas:

- Capital losses following a change in ownership. In December 2005, the Government introduced three Targeted Anti-Avoidance Rules (TAARs). The second TAAR was aimed at preventing 'capital loss buying', i.e. the practice of acquiring a company primarily for the purpose of gaining access to its capital losses, whether these are realised or latent. The Government believes that some of the existing legislation pre-dating the TAARs, which focuses on capital loss buying, can now be repealed. Following reform, this would leave the remaining rules to deal simply with the 'streaming' of losses acquired in the context of commercially driven acquisitions, where obtaining a tax advantage is not one of the main motivations.

- Value shifting and depreciatory transactions. The value-shifting rules have been identified as particularly complex, and therefore a priority for simplification. The Government accepts that companies and their advisers may currently need to spend a significant amount of time analysing whether commercially motivated transactions are caught by these provisions.
- Degrouping charges. The degrouping charge ensures that if a company leaves a group, holding an asset acquired through a tax-free transfer from a fellow group member within the last six years, then any gain or loss deferred at the time of the transfer is reinstated. However, in some circumstances the rules as currently drafted can lead to economic double taxation, and the Government accepts that this outcome should be revisited. The degrouping charge also presently falls on the company leaving the group, rather than the company that initially transferred the asset free of tax. The Government wishes to revisit the rules and consider how best to simplify them and to match economic outcomes with tax outcomes.

1.7 The Government would like to hear the views of business, as well as the views of representative bodies and tax advisers, on the proposals outlined in this discussion document, in order to develop more detailed proposals. This document contains a number of questions, which are summarised in Chapter 6. The answers the Government receives to these questions will assist in the development of more detailed proposals, which we would expect to publish in a future full consultation document by the end of 2009, with a view to bringing forward clauses for legislating at earliest opportunity.

1.8 The Government has received representations on a number of other areas within the capital gains regime for groups; for instance, on aspects of the Substantial Shareholding Exemption. While all policy is kept under review as a matter of course, the consultation process will focus solely on the issues included in this discussion document.

Budget 2009 announcement

1.9 At Budget 2009, the Government announced a measure to simplify the capital gains rule dealing with notional transfers within a group of companies. This is a useful simplification that was identified as a result of the dialogue with representative bodies preceding this discussion document. The Government considered that it could be introduced without further consultation.

1.10 Under current legislation, if a company (company A) within a group disposes of an asset to a third party, then that company and a second company (company B) within the group can jointly elect for the asset to be deemed to have been transferred from A to B immediately prior to the disposal. This enables capital gains and losses within a group to be matched without the need for companies to make physical transfers of assets. However, although the current rule[1] allows the matching of a group's capital gains with its losses in most circumstances, there are some transactions that are not presently accommodated, as the current rule only applies to disposals to third parties, and does not apply to other types of real and deemed disposals.

[1] Section 171A, Taxation of Chargeable Gains Act 1992 (TCGA)

1.11 The changes announced at Budget 2009 amend the rule, so that rather than deeming a transfer of an asset from one group company to another before the disposal, it instead deems a transfer of any gain or loss arising. The former restrictions on the circumstances under which the gain or loss arises will no longer apply. This simplified treatment will be available for gains or losses arising on or after the date that Finance Bill 2009 receives Royal Assent.

2 Policy context and principles

Background

2.1 The UK regime dealing with the capital gains of groups typically taxes assets when they are disposed of (i.e. on a 'realisation basis'), rather than whenever their market value changes (i.e. on an 'accruals basis'). There are strong practical reasons for taxing gains on a realisation basis, which include the following:

- It can be difficult to determine the true market value of an asset when it is not for sale;
- Companies may not have the means to pay the tax due if this is calculated on an accruals basis. This liquidity problem could force companies to sell assets; and
- Fluctuating market prices for assets could lead to an excessive compliance burden if accrued capital gains were taxed and accrued losses relieved, because companies would need to revalue their capital inventories annually.

2.2 However, a tax regime which taxes asset gains simply whenever those gains are realised can create an undesirable economic distortion, as companies have an incentive to defer disposing of their assets. As a result, the UK capital gains regime for groups of companies includes various measures designed to reduce distortionary effects and promote economic activity. These include the 'no-gain-no-loss' asset transfer rule, which allows companies within the same corporate group to transfer assets between one another tax free; rollover relief, which defers a charge to tax on gains realised from the disposal of particular trade assets, to the extent that the proceeds from the disposal are then reinvested in other trading assets; and the Substantial Shareholding Exemption (SSE), which permits trading companies to dispose of shareholdings of 10 per cent or more of the share capital of other trading companies without incurring a capital gains charge.

2.3 As a result of provisions designed to remove economic distortions and of the interactions between the capital gains rules and other tax rules, the capital gains regime for companies has a necessary degree of complexity. Coupled with this, the intricacy of some group ownership structures complicates further the rules on transactions involving groups of companies. For groups of companies, complexity in the rules can also arise from the fact that there is frequently a choice of routes available to dispose of assets: either through a simple sale of the assets, or through a sale of the shares in a company that owns the assets. While such choices are usually driven purely by commercial reasons, tax considerations can sometimes distort the choice made. The inherent complexity of the regime has also provided tax avoidance opportunities, especially in situations involving groups of companies. This, in turn, has led successive governments to introduce various anti-avoidance measures to protect Exchequer revenue.

2.4 While there is necessary complexity within the capital gains rules for groups of companies, the Government nonetheless believes that there is scope for simplification, either by clarifying the existing rules, by improving their design, or by repealing parts of the legislation that have been superseded.

Initial discussions

2.5 In addition to aiming to simplify legislation, the Government has also made clear from the outset of the related companies simplification review that it regards the matching of tax outcomes with economic outcomes for groups of companies as another goal. This helps ensure fair tax treatment between taxpayers and reduces the distortion to commercial decision-making.

2.6 Given this broad agenda, the initial discussions between the Government and business representatives focussed on outlining characteristics that are desirable in a capital gains regime for companies. The starting point for these discussions was that capital profits should be subject to taxation. In overview, a broad consensus was reached that:

- A group should typically be viewed as a single entity, with its capital profits taxed on a realisation basis;
- Symmetry of treatment should apply between gains and losses, and intra-group transfers should typically have no tax effect; and
- Gains and losses should be based on the economic profit or loss arising for a group, with such gains and losses reflecting any change in value over the time an asset is held by the company or group.

2.7 The proposals outlined in the following chapters, and have been guided by the themes outlined above. Any reforms arising from this review will be consistent with the requirement that the underlying policy and anti-avoidance functions of the existing regime are to be preserved.

3 Capital losses after a change in ownership

3.1 'Capital loss buying' is a term used to describe any scheme in which a company ('Loss Co') is acquired by a new group primarily for the purpose of securing access to its capital losses, whether these are realised or latent. The loss-buying rules contained in Schedule 7A Taxation of Chargeable Gains Act 1992 (TCGA) were enacted in 1993 as a measure to prevent companies from being able to access losses that arose in a company in another group, to offset their own capital gains.

3.2 The losses in question may have arisen before Loss Co joined the group, or they may arise on a subsequent disposal of an asset which Loss Co brings into a group. The rules in Schedule 7A limit the scope for capital loss buying, but they do not contain a purpose test and so are not confined to cases where a group acquires a company primarily to obtain the benefit of realised or unrealised capital losses. The rules also provide a mechanism for 'streaming' losses. This ensures that losses can, broadly, only be used against gains on assets that were owned by the company when it joined the group or against assets acquired subsequently which are used for a trade conducted by the company when it joined the group. Allowing capital losses to be used in this way removes a tax barrier to restructuring a trade, while protecting Exchequer revenue.

3.3 In Finance Act 2006, the Government introduced three Targeted Anti-Avoidance Rules (TAARs), each dealing with different aspects of tax avoidance schemes involving capital losses. The second of the TAARs, at sections 184A and 184B TCGA, provides additional defences against capital loss and gain buying. The capital loss buying TAAR was necessary because of a significant increase in the number of avoidance schemes designed to circumvent the rules in Schedule 7A.

3.4 Consequently, there is a significant overlap in the functions of the old Schedule 7A and the capital loss buying TAAR. The TAAR applies in precedence to the old rule, but only in cases where there is an intention to secure a tax advantage. Schedule 7A rules have continued to apply in all other cases, providing the basic rules for determining how capital losses are treated following mergers or acquisitions. As such those rules are not restricted to cases involving tax avoidance.

3.5 Following discussions with stakeholders, the Government believes that some of the previous loss buying rules in Schedule 7A can be repealed, resulting in much simpler legislation that will continue to provide the necessary framework to 'stream' capital losses in commercially motivated company acquisitions where tax avoidance is not a main purpose. This can be achieved in a number of ways, but essentially it is possible because one of the main purposes of the old rule, to provide protection against deliberate tax avoidance, is now covered by the TAARs. In practice, the sole remaining function of the old rule is to provide a rule to stream the losses of a company joining a new group.

Proposed options

3.6 The legislation in Schedule 7A acts to stream the capital losses that arose under the former ownership of a company prior to its joining a new group. The Schedule therefore acts in a similar way to the income loss streaming rules in section 768 Income and Corporation Taxes Act 1988 (ICTA), but where the latter take up less than two pages of legislation, the loss buying rules run into more than 14 pages. In addition, the rules operate in a mechanical way to take account of the various methods by which losses could be streamed, either by reference to the market value of the asset at the time a company joins a group, or using time-apportionment (based on how long the asset has been held).

3.7 The Government has focused its attention on the following possible methods for simplifying the rules:

- 3A Repeal only those parts of Schedule 7A that are no longer required following the introduction of the second TAAR (section 184D, TCGA).
- 3B Align the change of ownership rules retained within Schedule 7A with the approach of the second TAAR.
- 3C Repeal the loss buying rules in Schedule 7A and introduce in their place a permissive rule that allows realised capital losses to be carried forward without restriction in cases where the losses relate to a trade or business that continues in a recognisable form.
- 3D Repeal the loss buying rules in Schedule 7A without replacement.

3.8 Option 3A would still leave in place a lot of the mechanical and complex rules, including the time apportionment and the market value provisions. Without these provisions, establishing the pre and post entry elements of the loss would be unduly burdensome for companies.

3.9 Option 3B has been considered following the recent litigation cases of Prizedome and Limitgood[1]. The litigation concerned the interpretation of those parts of Schedule 7A that set out when the restrictions on the use of losses apply, particularly in the circumstances where a company has been a member of a number of different groups. On the taxpayers' interpretation, a company that changed ownership twice (or more) would no longer have been subject to the restrictions imposed by the legislation. HMRC disagreed and successfully contended that the legislation operates successfully to stream losses on a change of ownership, irrespective of subsequent events. Although the Courts upheld HMRC's view, it is clear that the complexity of the rules created genuine confusion.

3.10 Adopting the same clearer approach to identifying when a company is regarded as changing ownership for both the TAAR and a new loss streaming rule would remove some of the more difficult areas that are at present contained within paragraphs 1 and 9 of Schedule 7A.

3.11 The aim of option 3C would be to draft a permissive rule that states when losses can be used and replaces the complex mechanical rules to be found in paragraph 7 of Schedule 7A. Under this option, it is proposed that there would be no need to time-apportion losses realised after a change of ownership on the disposal of pre-entry assets, allowing a further simplification compared to the current rules.

3.12 Option 3D is not considered viable as Government's view is that the rules within Schedule 7A still have a role to play in restricting the use of losses following a change in ownership of the relevant company, and thus in performing the required streaming function.

3.13 Of the options listed above, the Government currently favours 3B and 3C. Discussions with stakeholders have suggested that a combination of these options would provide a significant simplification. Since the introduction of the second TAAR, it has become apparent that the old loss-buying rules are no longer needed to fulfil an anti loss-buying function. Instead, those rules could be concentrated on the streaming of losses that were realised in a company before a

[1] Prizedome Limited & Limitgood Limited v HMRC 2009 EWCA Civ 177

change of ownership. Stakeholders have also expressed a strong preference for avoiding the complexity of any time-apportionment or market-value elections. The Government is also conscious that a permissive rule should also reduce the administrative compliance burden.

Questions

3(i) Do you agree that a combination of options 3B and 3C would be the most effective approach to simplification, given the need to preserve the streaming of losses realised in a company before a change of ownership?

3(ii) If not, which option or combination of options do you consider would be the most effective and why?

3(iii) Would any of the options have any significant impact on business beyond reducing compliance burdens?

3(iv) Are there any other options for simplifying this area of legislation?

4 Value shifting and depreciatory transactions

4.1 When the simplification reviews were announced at PBR 2007, the responses to the anti-avoidance review identified the value-shifting rules as being particularly complex and time-consuming to work through, and therefore a priority for simplification. The Government acknowledges that companies and their advisers may currently need to spend a significant amount of time analysing whether commercially motivated transactions are caught by these provisions.

4.2 A depreciatory transaction is simply a transaction which reduces the value of an asset. The depreciatory transaction rules in section 176 TCGA (extended to non-group situations by section 177 TCGA) restrict the allowable loss on a disposal of shares or securities where there has been a depreciatory transaction. However, those provisions cannot convert a loss into a gain or increase the amount of a gain.

4.3 Stakeholders have indicated that they consider that section 176 is straightforward to apply and that there is usually no difficulty agreeing the amount of any adjustment. The only significant concern expressed has been that no time period is set within which a transaction is subject to the rules.

4.4 In addition, not all depreciatory transactions are undertaken in order to reduce the amount of tax that companies pay. The Government accepts that entirely commercial arrangements that have the effect of creating or augmenting a loss on shares or reducing a gain might not have the intention of obtaining a tax advantage.

4.5 The value shifting rule at section 30 TCGA provides for the consideration for a disposal to be increased by a just and reasonable amount where a scheme or arrangements materially reduces the value of an asset and gives rise to a tax-free benefit. In cases where the result of a depreciatory transaction is to avoid a tax charge on a gain, the value shifting provisions may apply, re-imposing the gain. Transactions within groups of companies were excluded from this provision when it was introduced. This is because of the risk that the provision could otherwise have imposed an additional charge, even when the economic gain to the group had been recognised in calculating the chargeable gain on another disposal.

4.6 The exclusion for transactions within groups of companies was exploited by schemes that sought to reduce artificially the value of shares that were to be sold and to arrange for the difference in value to return to the vendor in a non-taxable form, such as the repayment of a loan. These were known as ‘drain out dividend schemes’. Section 30 was then extended to certain group transactions by section 31 and later by section 31A.

4.7 Sections 31, 31A and 32-34 TCGA aim to avoid the risk of imposing double taxation by limiting the application of section 30 to tightly prescribed circumstances. This has led to detailed and prescriptive legislation that nonetheless is seen as capable of applying to a wide range of transactions.

4.8 For example, section 31 seeks to apply an adjustment under section 30 where an intra-group dividend is paid out of a profit that has not been subjected to tax; but not if there has also been another disposal that would take that profit into account. The legislation achieves this by spelling out three particular types of transaction that could lead to such a profit, including two further conditions, and then disapplying the result if certain other conditions are met. If a particular one of the initial set of conditions is not met, then section 30 can still apply provided the further detailed conditions of section 31A are met.

4.9 There is clearly some overlap between the value shifting rules and the depreciatory transaction rules. However, the relevant time limits differ and the depreciatory transactions rules only impact in loss situations. The Government accepts the need to address the current position.

Options discussed

4.10 Any new rule dealing with value shifting would need to apply following a transaction that results in an understated gain or an overstated loss. The rule would negate the effect of transactions reducing the value of a company in a group, while the economic value taken out of the shares remains in the group. No adjustment would be appropriate where the movement of value represents income or gains already taxed within the group.

4.11 Whatever approach is taken to value shifting within groups, the core legislation in section 30 will need to be retained, given its wider application: for example, to transactions involving companies that take place outside of a group context. By whatever means simplification is achieved in this area, the Government considers that it should possible to stop section 30 applying where a reduction in value is caused by either the payment of a dividend or the transfer of an asset within a group. That will mean that section 30 would apply largely as when first introduced.

4.12 The key alternative options that have been discussed with business representatives are:

- 4A Simply to extend the existing depreciatory transaction rules to allow for adjustment to gains on shares (including the creation of a gain); or
- 4B Retain the existing depreciatory transaction legislation and create a new value shifting rule within the chapter of TCGA dealing with groups of companies[1] which would be effect based as in the present depreciatory transactions rules.

An additional separate option was also discussed:

- 4C In addition to the above, to align the time limit for adjustments between the two sets of rules, to six years (to match the present provision in section 31).

4.13 The Government considers that adopting option 4A in its simplest form would not be sufficient. Additional rules would be needed to ensure that an adjustment would result following a transaction that would be within the current value shifting rule at section 31 but not within section 176. For example, it is unclear as to whether section 176 applies to a transfer of an asset at its market value, yet such a transaction can result in a reduction in value of the shares in the company that acquires the asset. That is because, in the group context, the acquiring company will take on the tax base cost of the asset.

[1] Part VI, Chapter 1 TCGA

4.14 The Government believes that there is a case to be made for having a single rule to address what is essentially a single issue, and it acknowledges that option 4A would provide an opportunity to simplify the existing language of section 176. Although this section appears to be well understood and operate well, there are some aspects that might be clarified. For example, the factors to be taken account of in arriving at a ‘just and reasonable’ adjustment appear to be very much focussed on only those present at the time of the depreciatory adjustment.

4.15 There is also a case to be made for the opposing view that because section 176 is well understood, it should be left intact, but inform a stand-alone group value shifting rule. However, this approach would leave open the question of addressing situations where the provisions could overlap. Because of the potential difficulties which option 4A would involve, the Government’s current view is that option 4B is the more viable.

4.16 One of the main comments made during the discussions was that the absence of any time limit to the depreciatory transactions rules adds a significant compliance cost as companies seek to ensure that the rules do not catch previous transactions. Discussions indicated that it was very difficult to identify such potential transactions if there had been mergers or acquisitions and where staff had moved on. The Government is concerned that introducing a time limit to section 176 (option 4C) would mean that commercially driven transactions which did not result in any economic loss could nonetheless produce allowable tax losses. However, the Government welcomes reasoned views on this matter.

4.17 The main principle that the Government feels should form the basis of the new rule is that when a group company is sold following a reduction in value that has not been taxed, then the profit or loss on the sale should be adjusted to the extent that the reduction in value reflects profits that have not been taxed within the group. The tax gain or loss should be adjusted to reflect commercial transactions and the provision should deter tax driven transactions.

Questions

4(i) Do you support the idea that the section 30 TCGA value shifting provisions applying to intra-group dividends and asset transfers be replaced by a less prescriptive, principles-based provision within the corporate groups code?

4(ii) Do you feel that the present depreciatory transactions rules in section 176 should be amended so as to apply to augment or create a gain (option 4A) or would you prefer to see a separate rule to do this (option 4B)?

4(iii) The key requirement for a new rule appears to be that where there has been a sale of shares in a group company whose value has been reduced then the profit or loss can be adjusted to the extent that the movement in value has not otherwise been taxed within the group. Are there any other requirements that you would see as fundamental to the rule?

4(iv) Please outline any rationale for or against the view that transactions should be covered by value shifting/depreciatory transaction provisions only if they take place within a certain period before the share disposal. If you think that they should, please provide your reasoned view on the six year limit suggested in option 4C.

5 Degrouping charges

5.1 Assets transferred between companies within the same capital gains group are generally treated as taking place at a value that creates neither a gain nor a loss for tax purposes. Recognition of a taxable gain or loss on the disposal of the asset is deferred until such time as the asset is disposed of outside the group.

5.2 Since 1968, the 'degrouping charge' rule (section 179, TCGA) has ensured that if a company leaves its group with an asset acquired from a fellow group member within the last six years, any gain or loss deferred from an earlier date is reinstated. As such, its purpose is to ensure that a tax charge arises whenever a company leaves a group having recently acquired an asset from another group company and to counteract any advantage that might otherwise be obtained by asset transfers within the group.

5.3 During discussions, stakeholders agreed that some form of de-grouping charge is necessary to protect the tax system. Without such a charge it would be possible to avoid corporation tax on profits from the sale of assets by transferring an asset into a newly incorporated company whose shares have been set up with a high tax base cost, and then selling the company (rather than directly selling the asset) so that there is no gain.

5.4 The issue business representatives most commonly cited as creating an administrative burden was the six year time limit. In a continuing and stable group it is not difficult to obtain records of intra-group transactions over the last six years, but when a group merges with, or takes over, another group it can be difficult for the new owners to know precisely what transactions have occurred in the acquired companies over that period.

5.5 In addition, economic double taxation can potentially arise as a result of the operation of the degrouping charge rules with gains on both the transferred asset and the subsequent share disposal being subject to tax. The rules are mechanical rules, with no test of purpose, and no mechanism to reduce the amount of a charge where double taxation would arise.

5.6 There may be no tax advantage if a group asset is sold to an existing group company which is later sold, but there may be one where a newly created company is used, even if this is for commercial reasons. In particular, for a single asset company a tax advantage may arise where the cost of the shares in the company sold is equivalent to the value of the asset transferred. However companies owning just a single asset are often sold for commercial reasons, and not to avoid corporation tax. For example, property sales often occur in this way, in order to maintain the continuity of leases to tenants. Transferring assets around a group – particularly before a re-organisation or demerger – is a common commercial practice and the complexity of the degrouping charge rules mean that there is a significant compliance and administrative cost to groups in ensuring that this does not give rise to economic double taxation.

5.7 A concern expressed by some stakeholders is that the current de-grouping charge could be seen to be targeting the wrong company. At present, a chargeable gain falls to the company owning the asset that leaves the group. However, the economic gain being taxed arose during the period the asset was owned by the company that transferred the asset. One consequence of the current rule is that any tax due is payable by the company that has left the original group unless there are commercial arrangements to reimburse any charge or the vendor and purchaser group companies jointly agree to make an election to transfer the gain to another company in the vendor group.

5.8 Additionally, a significant concern for a number of business representatives with the current degrouping charge rules is the way that these rules interact with the provisions in Schedule 7AC TCGA, the Substantial Shareholding Exemption (SSE). A degrouping charge can arise in respect of a trade asset owned by a trading company, yet the share sale which gives rise to the degrouping event would itself be an exempt disposal for chargeable gains purposes by virtue of the provisions in the SSE. The imposition of a degrouping charge on an otherwise exempt sale was one of the major irritants highlighted by business representatives, particularly in relation to groups that organise their business on a divisionalised basis, where restructuring the business is necessary prior to selling part of the overall trading operations in a corporate form. This interaction made the benefits of the SSE regime significantly less useful for such businesses compared to groups that conduct trading operations within discrete companies.

5.9 When degrouping charges were first introduced, the potential for double taxation of gains was identified, and an exception was provided that was intended to address this, at least in the majority of circumstances. This is the "associated companies" exception in section 179(2) TCGA, which can switch off the degrouping charge rules where the only asset transfers that have occurred are within a sub-group of companies that are all sold together. In such circumstances there should be no risk of tax avoidance being present because the asset transfers should not have moved value in to, or out of, any companies other than those included in the sale.

5.10 The associated companies exception has commonly been relied on to "switch off" potential double charges in the past. It is clear from comments about the judgement in a recent case to come before the Court of Appeal[1] that there were differences of opinion about the way in which this exception is to be applied. However, even where the exception is applied according to the interpretation preferred by HMRC, it can require some commercially unnecessary actions to achieve the desired tax outcome. One example quoted by stakeholders is that where the activities of a group company are being wound up and its assets transferred to other group companies, the dormant shell company cannot safely be liquidated for six years. This is because the original company may be needed if the associated companies exception is to be applied on a later sale of the consolidated business to prevent unexpected degrouping charges arising.

5.11 There are therefore a number of separate features of the current degrouping charge rules that place a significant administrative burden on groups, especially when an acquisition or disposal of all or part of a group's activities is being contemplated.

Options discussed

5.12 Several possible options to simplify the current degrouping charge rules were discussed with stakeholders:

- 5A Introduce a facility to make a just and reasonable adjustment to the degrouping charge through a taxpayer election where the present rules give a result that does not reflect a true economic profit.
- 5B Introduce a mechanism to switch off the degrouping charge where the whole gain is realised at the shareholder level, to replace the exceptions in the present section 179(2) TCGA.

[1] See Johnston Publishing (North) Ltd v Revenue and Customs Commissioners [2008] EWCA Civ 858; [2008] WLR (D) 253

5C Leave the degrouping charge as it stands, but look for a means to adjust the base cost of the shares in the company being sold, so that together the degrouping charge and any gain or loss on the share sale reflect the true economic profit from the whole transaction, and thereby eliminate any excess degrouping charge.

5D Amend the degrouping charge rules so that any charge will arise either in the transferor company or the group's principal UK company, providing for elections to subsidiaries if necessary.

5E Reduce the six year limit in the degrouping charge rules to three years.

5F Replace the current de-grouping charge with a principle based TAAR.

5.13 The Government believes that option 5A would be an effective means of ensuring that the correct outcome is reflected in the degrouping charge, but is concerned that some protection may be essential to ensure that the just and reasonable adjustment may not be used where the degrouping charge is less than what the actual economic outcome would be.

5.14 For options 5B and 5C above, the Government believes that a just and reasonable adjustment would most probably be a suitable way of ensuring a fair result rather than trying to craft bespoke mechanical rules that would attempt to provide a more accurate degrouping charge calculation for every possible scenario.

5.15 For option 5D, it is envisaged that the degrouping charge attaches to the group making the disposal (rather than the company that is sold holding the asset). This would remove the instances where an election is made to transfer the gain back to the original group under section 179A(3).

5.16 For option 5E, business stakeholders felt that the tax planning horizon for major groups would be less than three years and reducing the time limit would bring it in line with the time limits for stamp duty. It was however acknowledged that the presence of a time limit is already a relaxation from a strict approach of the principles, and some other similar anti-avoidance rules do not have such a restriction. Companies are also required to keep all records in support of their accounts for six years under company law, and so it can be argued that the requirement to keep tax records for this duration does not create an excessive additional compliance burden. In addition to these considerations, the Government remains concerned that a reduction of the present limit could significantly weaken the effectiveness of this anti-avoidance rule, and takes the view that six years represents an appropriate compromise between effectiveness and practicality.

5.17 The Government believes that a rule targeted only at deliberate avoidance, as proposed under option 5F, would not provide a viable alternative for degrouping charges. The rules are sometimes needed to arrive at the correct amount of taxable gain or loss in cases where there is no manipulation and all intra-group transactions have been undertaken at market value for purely commercial purposes. Degrouping charge rules are needed because transactions undertaken at the asset level can have very different results to essentially the same commercial transaction undertaken at the shareholder level, purely as a result of the 'history' of a shareholding, a characteristic that is shared with the value-shifting and depreciatory transaction rules discussed in Chapter 4.

5.18 The Government therefore feels that the most viable options are 5A and 5D.

Questions

5(i) Would the proposed just and reasonable adjustment in option 5A provide adequate reduction in compliance and administrative burdens for companies?

5(ii) Would option 5D result in a lower administrative burden than the present arrangements for electing a gain back into the vendor group?

Interaction with the Substantial Shareholding Exemption

5.19 The SSE introduced in Finance Act 2002 provides an extensive tax relief for trading companies and trading groups by permitting them to dispose of shareholdings of 10 per cent or more of the share capital of other trading companies without incurring a capital gains charge. It allows groups to restructure for commercial reasons, without being constrained by tax considerations. The exemption was introduced as part of the Government's programme to modernise the system of company taxation and to improve international competitiveness. Business contributed significantly to the design of the exemption through wide-ranging consultation. In most cases the relief is simple to administer, and does not require additional record-keeping requirements or other burdens on businesses affected.

5.20 While it is intended that the exemption is straightforward to apply and equally available to all trading groups, it does have some important conditions to ensure that it is primarily of benefit to the intended target of trading groups. One condition for the SSE to apply is that the group that is making the disposal has been carrying on the trade that is disposed of for at least twelve months. This policy objective is translated into two statutory rules:

- That the company disposed of has been a trading company (or the holding company of a trading sub-group) for a continuous period of 12 months; and
- That the group making the disposal has owned at least the minimum qualifying holding of 10 per cent of the shares in the company that is disposed of for at least twelve months.

5.21 One of the main concerns raised by stakeholders in discussions is that parts of the rules can present difficulties for businesses organised on a divisionalised basis, because of the extent to which it may be necessary to restructure their operations to make an exempt share level disposal of a trading operation. Even though such a disposal may be within the scope of the policy of the exemption, it will not apply unless the company that is sold conducts a trade for at least 12 months.

5.22 An additional issue for divisionalised businesses that need to re-organise their assets into a corporate entity prior to sale is that they are likely to incur degrouping charges as a consequence.

5.23 It is not clear that the interaction with degrouping charges is wholly consistent with the policy aim of the SSE. In broad terms the SSE allows for sales of trading subsidiaries without a tax charge arising where the trade in question has been carried on in the group for more than twelve months. So while the SSE may allow an exempt sale of the corporate entity at the share level it is not entirely consistent with the policy aim that a degrouping charge may still be incurred if trade assets are transferred into that corporate entity from a divisionalised structure.

Options discussed

5.24 In initial discussions with business representatives as part of the Related Companies Simplification Review, the Government considered two main options that would prevent companies incurring degrouping charges arising on the sale of assets as part of a SSE exempt disposal of trading operations by a trading group. The first of these was a new exemption, within the capital gains regime for companies, for disposals of trading assets that amounted to a disposal of a separable trade by a trading group. This was not pursued for a number of reasons, the principal ones being that it was felt to fall outside of the remit of 'simplification' and that the process of ensuring it could be delivered without creating opportunities for unfair tax advantages to some users would be complex and time-consuming. There is no change in the Government's thinking on this issue and it is not proposed that a trading asset exemption will be introduced as a consequence of this consultation process.

5.25 The Government's preferred option is:

> 5G The degrouping charges rules could be disapplied in respect of trade assets where a disposal of shares in a group company qualifies for the exemption under SSE.

5.26 In order to be fully effective for divisionalised businesses that restructure in advance of a business disposal, this option would also require an amendment to the rules regarding the period of time that the company has carried on the trade prior to disposal, so that account is taken of periods where the trade is carried on by other members of the group.

5.27 The intention is that option 5G would remove one of the difficulties encountered by divisionalized trade groups in planning around the degrouping charge when seeking to benefit from the SSE.

Questions

5(iii) Would the proposed switch off of the degrouping charge under the option outlined in 5G be adequate to ensure that all divisionalised trades that are restructured to ensure that the disposal of a subsidiary would fall within SSE achieve the correct tax outcome?

5(iv) Are there any likely behavioural consequences that may lead to abuse of the switch off from the degrouping charge in option 5G that Government needs to consider?

6 Questions for consideration

6.1 The Government invites comments from interested parties in seeking to deliver genuine simplification. In particular, the Government would welcome views from groups of companies and their representatives on the questions asked in this discussion document and in particular whether the simplification ideas discussed above could provide benefits to their businesses. Work will only be taken forward if there is genuine support for the ideas outlined in this document.

Loss buying rules

3(i) Do you agree that a combination of options 3B and 3C would be the most effective approach to simplification, given the need to preserve the streaming of losses realised in a company before a change of ownership?

3(ii) If not, which option or combination of options do you consider would be the most effective and why?

3(iii) Would any of the options have any significant impact on business beyond reducing compliance burdens?

3(iv) Are there any other options for simplifying this area of legislation?

Value shifting and depreciatory transactions

4(i) Do you support the idea that the section 30 TCGA value shifting provisions applying to intra-group dividends and asset transfers be replaced by a less prescriptive, principles-based provision within the corporate groups code?

4(ii) Do you feel that the present depreciatory transactions rules in section 176 should be amended so as to apply to augment or create a gain (option 4A) or would you prefer to see a separate rule to do this (option 4B)?

4(iii) The key requirement for a new rule appears to be that where there has been a sale of shares in a group company whose value has been reduced then the profit or loss can be adjusted to the extent that the movement in value has not otherwise been taxed within the group. Are there any other requirements that you would see as fundamental to the rule?

4(iv) Please outline any rationale for or against the view that transactions should be covered by value shifting/depreciatory transaction provisions only if they take place within a certain period before the share disposal. If you think that they should, please provide your reasoned view on the six year limit suggested in option 4C.

Degrouping charges

5(i) Would the proposed just and reasonable adjustment in option 5A provide adequate reduction in compliance and administrative burdens for companies?

5(ii) Would option 5D result in a lower administrative burden than the present arrangements for electing a gain back into the vendor group?

5(iii) Would the proposed switch off of the degrouping charge under the option outlined in 5G be adequate to ensure that all divisionalised trades that are restructured to ensure that the disposal of a subsidiary would fall within SSE achieve the correct tax outcome?

5(iv) Are there any likely behavioural consequences that may lead to abuse of the switch off from the degrouping charge in option 5G that Government needs to consider?

Compliance burdens and wider impacts

6.2 The central aim of the policy options is to simplify the legislation on the capital gains rules for groups of companies, as this has been identified as an area where simplification would be particularly useful. HMRC welcome responses from companies on existing costs of complying with existing legislation that comes within the scope of the discussion document.

6.3 If your company and/or wider group has in the past 5 years been subject to either:

- the loss buying rules under Schedule 7A TCGA;
- the value shifting rules under sections 30-34 TCGA;
- the depreciatory transactions rules under sections 176 and 177 TCGA; or
- the degrouping rules under section 179 TCGA;

then we would be grateful if you could provide details of:

6(i) Any 'one-off costs' to you associated with the legislation such as: training and recruiting personnel, forward planning in respect of this legislation, developing systems to model the legislation or impact, researching the legislation or other similar transactions, negotiations or advice from external agents or consultants etc. This includes, for example, any costs associated with delays to a proposed asset sale in order to comply with the legislation/maximise the tax efficiency of the sale in light of the legislation or comply with the six year rule imposed by the degrouping rules under section 179 TCGA.

6(ii) Any ongoing costs associated with the legislation such as: the cost of directly compiling the computations relevant to this legislation, maintaining those internal IT systems dealing with this aspect of the rules, paying external agents etc.

6(iii) Any examples of delays in the sales of companies, in company restructuring or in the transfers of assets brought about by the degrouping charge rules, the value shifting rules and the depreciatory transaction rules.

6(iv) HMRC and HMT would also be keen to know if your company or wider group considers any of the options to have a more significant impact than others, with any explanation you can provide as to why.

6(v) Do you represent a large group of companies (i.e. a group of 20 or more companies) or a group with fewer than 20 subsidiaries?

7 Next steps

7.1 This discussion document outlines the main areas that had been identified in the responses following the announcement of the related companies simplification review at the 2007 Pre-Budget Report. The Government feels that the key options that have been outlined in each of the areas offer the prospect of useful simplification for groups of companies, and has outlined some of the ways in which these ideas might work in practice.

7.2 HM Treasury and HMRC will continue to discuss options with business and other key stakeholders, to consider in detail the challenges and opportunities presented by the ideas outlined in this paper.

How to respond

7.3 The Government welcomes comments on the questions in this discussion paper. Any comments should be sent to:

The Related Companies Simplification Review Team
Room 2/E1
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

Alternatively, please email: relatedcompanies.simplification@hm-treasury.x.gsi.gov.uk

Telephone enquiries: 020 7270 6104

7.4 Comments should be received by 30 September 2009.

Proposed workshops

7.5 The Government intends to hold workshops to discuss stakeholder views and any further ideas during September 2009. Please send your expressions of interest to the e-mail address above and indicate your preferred dates by 31 July 2009. You will receive a reply by email with details on when and where the workshops will be held.

Confidentiality disclosure

7.6 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

7.7 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarding as binding on HM Treasury or HM Revenue & Customs (HMRC).

7.8 HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A The Government's Code of Practice on consultation

About the consultation process

This consultation is being conducted in accordance with the Government's Code of Practice on Consultation. If you wish to access the full version of the Code, you can obtain it online at:

http://www.berr.gov.uk/files/file47158.pdf

The consultation criteria

1. When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.

2. Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

3. Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

4. Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

5. The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

6. Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

7. Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Better Regulation Unit
Email: richard.bowyer@hmrc.gsi.gov.uk
Telephone: 020 7147 0062

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
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1 Horse Guards Road
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ISBN 978-1-84532-604-3

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