

# CONTENTS

---

	<b>Page</b>	
Chapter 1	RIA for Tax Relief for Spinout Companies from Universities and Research Institutions	<b>3</b>
Chapter 2	Regulatory Impact Assessment for Modernising the Tax System for Trusts	<b>11</b>
Chapter 3	Regulatory Impact Assessment for Gift Aid and Admissions	<b>17</b>
Chapter 4	Regulatory Impact Assessment for Shari'a Compliant Financial Products	<b>27</b>
Chapter 5	Regulatory Impact Assessment for European Company Statute	<b>39</b>
Chapter 6	RIA for Changes to the Quarterly Instalment Payments Regime for Oil Companies	<b>45</b>
Chapter 7	Regulatory Impact Assessment for Business Premises Renovation Allowance Scheme	<b>51</b>
Chapter 8	Regulatory Impact Assessment for Tonnage Tax	<b>61</b>
Chapter 9	Regulatory Impact Assessment for VAT - Package of Partial Exemption Measures	<b>69</b>
Chapter 10	RIA for Reduced Rate VAT on Air Source Heat Pumps and Micro CHP Units	<b>73</b>
Annex A	Appendix to Regulatory Impact Assessment for Pension Simplification	<b>77</b>
Annex B	Summary of Responses to Consultation - Tax Relief for Spinout Companies	<b>81</b>
Annex C	RIA - The European Company Statute, Issued by DTI (Oct 2003 Consultation Document)	<b>89</b>



# RIA FOR TAX RELIEF FOR SPINOUT COMPANIES FROM UNIVERSITIES AND RESEARCH INSTITUTIONS

## Purpose and Intended Effects of the Measure

### *The Policy Objectives*

**1.1** This regulatory impact assessment considers a new tax measure to help researchers acquiring shares in spinout companies created with universities and research institutions to ensure that the income tax system does not present any unfair barriers to the formation of spinout (sometimes referred to as ‘spin-offs’) companies from Research Institutions (RI)<sup>1</sup> by virtue of their intellectual property (IP) sharing policies. Such policies typically pass value in the form of shares in the new company to researchers<sup>2</sup> employed by the RI who commit part of their working time to developing the IP in the new enterprise. An unfair barrier would be one that inhibits spinout formation compared with other businesses founded to develop IP in the economy.

### *Background*

**1.2** Academics, and other individuals employed by RIs often work on research that may have a commercial application. Stand-alone companies are often set up between a RI, researchers and a funding partner to further develop IP to the point where it is ready for commercial exploitation. These companies are commonly referred to as “spinout” companies.

**1.3** IP created by employees of RIs is the property of the employing entity. The employing organisations generally have policies in place under which they agree to share any income or gains generated by the IP with the employees who created it. They can do this either by making cash payments to the employees or by using shares in a spinout company set-up specifically to further develop the IP. The latter path facilitates innovation as it means that the further development of the IP within the spinout company will continue to benefit from the researcher’s input. If the spinout is successful then the researcher will benefit from the growth in value of the shares.

**1.4** Schedule 22 of Finance Act 2003 reformed the rules on the taxation of employment-related securities and shares to bring parity between earnings taken in cash or by means of shares and other securities. Before this legislation came into force the view taken by the RI sector was that shares held by their employees in spinout companies were subject only to Capital Gains Tax when the shares were sold. The Revenue was not aware of this view and had not therefore challenged it. The numbers involved are not large with around 250 spinouts created per annum at their peak. More information is at paragraph 1.18. The majority of the spinouts are developing research in the pharmaceutical, bioscience and new technologies sectors. There were nine initial public offerings by companies formed from universities in 2004. The combined value of the spinouts listed in 2004 was £604 million.

**1.5** Schedule 22 Finance Act 2003 made it clear that shares or securities held by RI employees in spinout companies are "employment-related". Any discount at the time the shares are acquired or any later increase in value over and above normal commercial growth (for example, such as that following the transfer of IP to the

---

<sup>1</sup> This term is used to describe universities and publicly funded research establishments.

<sup>2</sup> Academics and other staff undertaking research.

spinout) is subject to income tax and National Insurance Contributions (NICs) in the same way as cash payments under the IP sharing policy.

### ***The Issue***

**1.6** The structures typically adopted by RIs' spinouts trigger income tax charges when the IP is transferred into the company. However, this is usually at a time when the employee has no funds to pay any tax charges. The barrier this creates has been cited by the sector as one of the main reasons for the downturn in recent spinout activity.

**1.7** The UK technology transfer sector has strong potential to contribute to UK innovation and enterprise. Consequently, the downturn in activity has a potential knock-on effect to the UK's long-term economic performance.

**1.8** Evidence gathered by the Universities Companies Association (UNICO), a professional association involved in the university IP transfer sector, indicates that the impact of Schedule 22 has caused a decline in spinout activity. Spinouts were reducing in numbers before Schedule 22, so it is not clear the tax issue is the only reason for the decline. Difficulties in obtaining funding, lack of finance and resources, commitment of academics, poor infrastructure and lack of understanding of the rigours of the market place are some of the other reasons why many spinouts fail. Responses to the consultation did not provide evidence of the number of spinouts that did not proceed because of Schedule 22 but they confirmed that the legislation had added a complication and delay to some spinout creation. At least one RI had recommended that spinouts should not be used, although in the event even their spinout company had gone ahead.

### **Options**

#### ***Do Nothing***

**1.9** To do nothing risks the freeze in RI spinout activity continuing, to the detriment of innovation and long-term economic performance of the UK.

#### ***The Non-Statutory Route***

**1.10** Inland Revenue had worked with sector representatives and two structural solutions were developed to ensure that an income tax charge does not arise unless and until the venture is successful. This allowed some spinout activity to resume, which was confirmed by the consultation although it was not possible to establish the number of companies that have used the models.

**1.11** While the sector accepts that these solutions provide a level of certainty at the start of the spinout company in terms of tax treatment, they argue that an income tax and NIC liability arising on the value of the shares when the spinout company is sold or listed does not make the models attractive to the researchers whose expertise is critical to the venture. Appreciable tax barriers to spinout formation clearly remain under this option.

**1.12** Feedback is that RIs consider it important to be able to use simple corporate structures that ensure the researchers commitment to the venture through share ownership, whilst avoiding the need for complex share acquisition agreements. They also suggest valuation of IP is a difficult and costly process that places an additional

financial burden on those involved in the spinout activity at a time when funds are limited.

### ***The Legislative Option***

**1.13** This option would ensure that those researchers who are involved in the development of IP in a RI spinout are not hampered by the tax rules with regard to the transfer of the IP and its effect on their employment related securities. To do this effectively the measure would need to recognise the unique IP sharing arrangement present in RI spinout companies and limit the scope of the measure to that transaction.

**1.14** To achieve this aim a Finance Bill provision would deem the market value of the shares held by the researcher in the spinout to be unaffected by the transfer of the IP into the company. This would ensure no income tax and NICs charge arises under Schedule 22 in relation to the IP transfer event.

**1.15** The statutory provision proposed would provide tax certainty, reduce the need for costly professional advice on share valuation and the income tax and NICs implications of IP transfer arrangements and give the sector the flexibility it needs to adopt structures that meet the commercial considerations of the business. It recognises the unique arrangement present in RI spinouts and is therefore limited to that sector and to the IP transaction within it that causes the value to flow to the employee. If some other employment-related event increases the value of the researcher's shares that increase will be liable to income tax and national insurance contributions, as it would in any other company where employees hold such securities.

### **Business Sectors Affected**

**1.16** The proposed measure is targeted at employees of RIs who acquire employment-related shares in spinout companies, into which the RI transfers IP. As the nature of the IP can be very wide ranging, it is unlikely it will favour or impact on a particular business sector/activity. Given the nature and purpose of spinout companies, it is most likely all spinout companies affected will be small in size, with less than 50 employees.

**1.17** We understand universities create the majority of the spinouts, and the number of spinouts created by other RIs is very small. No feedback was received on the number of spinouts created by non-university RIs and what model they adopted to transfer IP. However, we were made aware of the fact that some NHS Trusts and charities collaborate with universities to jointly develop IP through a spinout company and the draft legislation reflects this.

**1.18** The Higher Education Business Interaction Surveys 2002 to 2004 show that 203 spinouts were established in 1999-00, 248 in 2000-01, 213 in 2001-02 and 197 in 2002-03. An informal UNICO survey has indicated a figure of around 90 university spinouts since April 2003. There are, however, no data available that shows how many researchers are involved in spinout companies in which they have share ownership. There was no specific feedback to this from the consultation but anecdotal evidence suggests between 120 and 150 researchers are engaged in spinouts created since April 2003.

### **Equity and Fairness**

**1.19** This measure is intended to remove a unique barrier that is currently inhibiting the creation of new RI spinout companies. It will level the playing field in this respect

between RI spinouts and other new business start-ups intent on developing IP, which do not face the same problems that flow from the IP sharing policy agreements.

**1.20** We do not consider the proposed measure to have any Human Rights Act (HRA) consequences or any race and equality impact.

## **Benefits**

### ***Economic***

**1.21** We anticipate that the economic benefits of removing the perceived tax barriers to spinout formation would flow from the creation of more spinouts. These benefits can be categorised as either direct to those involved in spinouts or remoter, indirect benefits to the wider economy. They are all extremely difficult to quantify because they depend on spinout success rates, the returns generated, and any improvement in innovation.

**1.22** The direct beneficiaries will be the shareholders in spinout companies: the RI, their researchers, and any outside investors. RIs can gain direct financial benefit from holding shares in higher numbers of spinouts where they succeed. Even where spinouts fail, RIs can benefit through reversion clauses in IP sharing agreements, if they return the IP to the RI in a more developed form (which can either be spun out again or licensed). RIs also gain from being able to better recruit and retain quality research staff. Researchers can gain from holding shares in successful spinouts that they would have been deterred from participating in without the legislative option. Outside investors into spinouts, such as venture capitalists, can benefit from a wider range of investment opportunities and potentially higher returns.

**1.23** Direct economic benefits also include anticipated lower compliance costs. RIs and RI spinouts in the future will experience reduced professional advisor costs, as the tax position relating to impact of IP transfer on employment-related securities will be certain. They will not have to consider alternative structures to defer the tax charge until the spinout is successful, nor will they have to seek an Inland Revenue Code of Practice 10 clearance to be certain of the tax position. It will also remove the need to obtain a valuation at an early stage of the spinout company for income tax purposes.

**1.24** Wider economic benefits come through improvements in innovation and competition, which benefits the UK's economic performance at the margin and can offer a better deal for consumers of the new and improved products potentially generated by greater spinout activity (see competition assessment).

**1.25** Comments received from the consultation suggest the increased legal and professional advisory costs because of the impact of Schedule 22 were £20,000 to £50,000 per spinout. These costs are in addition to the additional time spent on ensuring the spinout company followed all the correct steps. However, it is not possible to assert that the introduction of the new measure will remove these costs entirely. As with any commercial or business transaction, some initial professional advice may be necessary at least to ensure the spinout company is within the scope of the new legislation.

### ***Social and Environmental***

**1.26** It is not considered that this proposal is likely to have any direct social or environmental impacts.

## Costs

### *Economic*

**1.27** The Exchequer income tax and NICs cost of the measure are estimated to be negligible<sup>3</sup>. As some spinout shares grow in value and are disposed of by researchers, it is also estimated that the measure will generate a negligible capital gains tax Exchequer yield. Overall, the Exchequer impact is expected to be negligible.

**1.28** The likely costs involved with complying with the measure will include the researchers and RIs familiarising themselves with how the measure will operate. They will also need to satisfy themselves that their activity is within the scope of the exemption. There may be initial advisory costs associated with doing this. It is difficult to ascertain a figure for these costs and it may be tied with other costs incurred on setting up the spinout company. Most universities involved in spinout activity have dedicated offices to help and advise academics in creating spinout companies and therefore any initial one-off costs may be absorbed by the university providing the IP.

**1.29** No actual figures are available to help determine the cost associated with familiarisation of and establishing a spinout that benefits from the new rules. We consider some savings may be achieved in terms of professional advisory costs by those involved in spinouts because simpler share structures can be used.

### *Social and Environmental*

**1.30** This measure has no social or environmental costs.

### **Small Business Impacts**

**1.31** New spinout companies mostly fall into the micro-business category. It is unlikely that a spinout company will have more than 50 employees at the start of its lifecycle when the IP is transferred because at this point it is primarily a vehicle for researchers to further develop IP. Only once the IP is developed to a point where it has a commercial value is the spinout likely to expand and diversify into product manufacture. The impact of the measure will be to facilitate the creation of the RI spinout companies, by removing a unique barrier encountered by RIs setting up spinouts. The spinout company will not thereafter, directly benefit from the measure.

**1.32** The Small Business Service has seen this RIA and welcomes the measure.

### **Competition Assessment**

**1.33** The competition filter has been applied and concluded that the measure was unlikely to have any negative impacts on competition. Moreover, the measure has a potentially positive impact on the competitive process. The operation of the tax system has presented a barrier in a very discrete and narrow area relating to IP transfer, that we understand is unique to the RI sector. This barrier to entry for prospective spinouts has made it difficult for them to compete with other companies, who may be pursuing an innovation in the same niche areas. Removing the barrier creates a level playing field between spinouts and other business forms, which ensures that spinouts can contribute to the competitive process in markets where innovation is often the main form of competition.

<sup>3</sup> Defined as an Exchequer cost of less than £3 million.

**1.34** It might be claimed that other companies designing, developing and commercialising new technology would be disadvantaged, by not being able to access the measure. However, we understand that these companies do not share IP in the way RIs do with their employees and so there is no equivalent barrier.

### Securing Compliance

**1.35** It is envisaged that existing administrative processes will be used to identify spinout companies in order to deal with them in one location. This will enable the Inland Revenue to monitor the take up and effectiveness of the measure and ensure that it is not being abused. In turn, the spinout companies will benefit from consistent advice and staff accustomed to their particular circumstances. We do not envisage that this will impose any additional compliance costs on RI or companies and may even reduce them slightly. We aim to publish guidance on the new measure by the end of April 2005.

**1.36** We are proposing that spinouts, which benefit from the measure are notified to the Inland Revenue on Form 42 which would need to be completed anyway when researchers acquire shares in the spinout company. Any enquiries about the application of the legislation should be made to the Employee Shares and Securities Unit of the Inland Revenue.

### Consultation

**1.37** We consulted on the detail of the design and effect of the proposal with a range of sector representatives. We published a Technical Note to explain how the proposal will work and invited comments in the Note to be made within ten weeks of publication of that Note.

**1.38** The period of consultation was shorter than the Cabinet Office guidelines, which suggest a minimum of 12 weeks. This is because the draft legislation needs to be ready for publication of the Finance Bill, a process that does not allow in this instance for the usual consultation period.

**1.39** However as this was known, many comments were received early. The draft legislation was therefore able to take them into account and as a result it contains significant changes from what was envisaged in the Technical Note.

**1.40** The results of the consultation are produced on a separate document published on the Inland Revenue website under the same title as this RIA. In summary we received over 45 responses mostly commenting on the design and scope of the measure. There were some helpful comments received on the questions raised in the Partial RIA published on 2 December 2004. However, these have not led to any changes in costs, benefits and the direction of the measure as presented in this RIA.

### Monitoring and Evaluation

**1.41** RI spinouts and researchers will report to the Revenue the acquisition of employment-related securities that make use of this measure. This will provide the necessary information to help determine whether the measure is effective in returning activity to the RI spinout sector. In order to gauge the impact of this measure a review of the legislation will need to be undertaken in four years time. Any earlier assessment cannot be expected to reveal anything significant as the lifecycle of a typical spinout company can extend beyond three to four years. It is also important to note that there is

a high mortality rate in spinout companies caused by factors unrelated to this tax measure.

## Summary and Recommendation

**1.42** The provisions contained in this measure have been widely welcomed by those engaged in spinout activity. Spinout companies are a common way of facilitating the commercialisation of IP developed by RIs. It will help to restore the creation of spinout companies by removing a unique tax barrier affecting the researchers who acquire shares in these companies. The exploitation and commercialisation of IP would help to boost the overall productivity of the UK economy and therefore the benefits justify the costs.

## Contact Point

Hasmukh Dodia  
Employee Shares and Securities Unit (ESSU)  
Room G49  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2839

E-mail: [Hasmukh.Dodia@ir.gsi.gov.uk](mailto:Hasmukh.Dodia@ir.gsi.gov.uk)

## REGULATORY IMPACT ASSESSMENT

### Researchers Acquiring Shares in Spinout Companies Created with Universities and Research Institutions

#### Statement of Ministerial Approval

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

Signed by the responsible Minister:

John Healey  
Economic Secretary to the Treasury

Dated: 3 March 2005



# 2

## REGULATORY IMPACT ASSESSMENT FOR MODERNISING THE TAX SYSTEM FOR TRUSTS

---

### **Purpose and Intended Effects of the Measure**

#### ***The Policy Objectives***

**2.1** The objectives of this stage of the modernisation project are to reduce the burdens on smaller trusts and to ensure that certain trusts set up for the vulnerable do not pay more tax as a result of the change in the rate applicable to trusts (RAT) from 34 per cent to 40 per cent and in the associated Schedule F trust rate from 25 per cent to 32.5 per cent.

#### ***Background***

**2.2** At Budget 2004, the Chancellor announced that the RAT would be increased to bring it into line with the higher rate for income tax. The Government recognised, though, that this could have an impact on smaller trusts, trusts with vulnerable beneficiaries and those trusts whose beneficiaries are not higher rate taxpayers, so announced its intention to introduce a standard rate band for all trusts that pay tax at the RAT and a new regime specifically for certain trusts with vulnerable beneficiaries.

**2.3** The Government also recognised that the taxation of trusts is a very complex area, which can prove challenging for non-professional trustees. Therefore, alongside this, a series of proposals for simplifying the taxation of trusts were also put forward.

#### ***The Risks Being Addressed***

**2.4** The complexity of the way trust law interacts with the tax system means that trustees, particularly unrepresented and non-professional trustees, may make mistakes when completing their Self Assessment returns.

#### **Options**

**2.5** A variety of different options for modernising the tax system for trusts were put forward in the consultation paper issued on 13 August 2004. After considering the responses to this consultation, Ministers wish to take forward two of the ideas at this stage. These are:

#### ***Introducing a Standard Rate Band for all Trusts Paying Tax at the RAT***

**2.6** This will be set at £500. Below this level, trustees' income will be assessable at no more than the basic rate of income tax (currently 22 per cent), which means that many trustees whose income is taxed at source will have no additional tax to pay. Those trusts with income consistently below £500 will no longer need to complete an annual Self Assessment return – we estimate this will include around 25,000 of the trusts, which are currently liable at the RAT. This will, in turn, reduce their compliance costs.

### ***Trusts for the Vulnerable***

**2.7** There will be an election providing for certain trusts with vulnerable beneficiaries to be taxed as if the vulnerable beneficiaries owned the trust assets themselves. This will usually mean reduced tax bills for such trusts, because the trustees will be able to set the vulnerable beneficiary's personal allowances, and starting and basic rate bands against the assessable income.

### ***Other Measures***

**2.8** There are a number of other measures that were raised in the consultation document, such as introducing provisions for streaming income and harmonising definitions and tests in this area. The principles behind these were widely supported during consultation. However, many respondents expressed concern as to how the measures would work in practice, so the Government has asked the Inland Revenue to engage in further discussions on these proposals prior to their implementation. A discussion document has been published today and a further partial RIA will be published to accompany that future draft legislation.

### **Business Sectors Affected**

**2.9** The main sectors affected will be:

- the legal profession;
- professional trustees; and
- corporate trustees.

### **Issues of Equity and Fairness**

**2.10** The Government recognises the important role trusts play in society. As far as possible, it wants a tax system for trusts that does not provide artificial incentives to set up a trust but, equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits.

**2.11** The Government does not want a system that enables people to use trusts to avoid tax but, equally, as far as possible it does not want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as under the rules of intestacy.

**2.12** The Government is not attracted to changing legislation for the sake of change, so would prefer to build on what we have rather than start again from nothing. The Government wants to reduce the compliance burden on small trusts and believes that any new measures should:

- be fair;
- support the competitiveness of the UK economy; and
- be clear and easy to operate.

## Benefits

**2.13** The benefits of trusts modernisation will be:

- less tax paid by certain trusts established for vulnerable beneficiaries;
- less tax paid by all trusts that currently pay tax at the RAT; and
- thousands of smaller trusts will no longer have to complete a Self Assessment return every year.

## Costs

### *Policy Costs*

**2.14** None evident at this stage.

### *Implementation (Compliance) Costs*

**2.15** Implementation of the changes proposed would undoubtedly result in costs being incurred by those trustees who use automated systems for passing income out to beneficiaries and for completion of Self Assessment returns. There should, however, be savings for the smallest trusts, many of which will not have to complete a Self Assessment return each year.

### *Exchequer Effect / Distributional Impacts*

**2.16** The standard rate band for trusts will cost approximately £5 million, as it will reduce the tax bill for all trusts that pay tax at the RAT.

**2.17** The proposal to tax trusts for the vulnerable as if the income or gains arose to the beneficiary will also result in less tax being paid by some trustees.

### *Small Business Impacts*

**2.18** We consider that the impact of the changes on small business will be minor, although smaller trusts will benefit from the introduction of the standard rate band.

### *Other Costs and Benefits (Public and Private Sector)*

**2.19** There will be costs associated with any changes for the Inland Revenue. The trust and estate SA return will need to be amended, changes will be needed to the IT systems that support trust work, staff will need to be trained in the new systems and both internal and external guidance will have to be produced. There will also be costs associated with the changes for other parts of Government dealing with trusts, such as the Official Solicitor's Office/Office of the Public Trustee.

### *Unintended Consequences*

**2.20** There is a danger of people seeking to exploit the standard rate band by setting up several small trusts instead of one larger entity, but the savings from doing so are likely to be outweighed by additional administrative costs.

## Other Impacts

### *Devolution*

**2.21** None at present. The current review of Scottish Trust Law may have some minor implications for trusts modernisation, but consultation has taken place in both Scotland and Northern Ireland to ensure that changes will work consistently across the UK.

### *Human Rights*

**2.22** There are no implications under the Human Rights Act.

### *E-Policy*

**2.23** Trustees can continue to e-file their returns, as at present. No other impact.

### *Environmental Impacts*

**2.24** None.

### *Rural Proofing*

**2.25** None.

## Competition Assessment

**2.26** The package will impact, in the main, on trusts and will therefore be at a personal level rather than on business. To the extent that it affects professional trustees, we expect the impact of this stage of the project to be minimal.

## Securing Compliance

**2.27** One of the intended effects of the modernisation exercise is to make it easier for trustees, especially unrepresented and non-professional trustees, to comply with their tax obligations. The measures being suggested are aimed at reducing the tax paid by trustees and providing easier ways for small trusts and trusts for the vulnerable to comply, so there should be relatively little danger of non-compliance.

## Consultation

**2.28** Discussion papers were made public on 17 December 2003, and comments were invited from all interested parties. In addition, a number of discussion meetings were held in London, Edinburgh and Belfast. 117 people attended the nine discussion meetings and had the opportunity to comment directly on the proposals and to offer alternatives. 79 written responses were received.

**2.29** A formal consultation exercise began on 13 August 2004 and concluded on 5 November. This received a total of 67 responses and a further discussion meeting, this time focused on representatives of vulnerable groups, took place in London.

**2.30** This RIA is being published ahead of accompanying legislation that is intended to be put in place by Finance Act 2005. A discussion document has been issued today on the remaining measures put forward in the August 2004 document.

## Monitoring and evaluation

**2.31** We will monitor the number of trusts who take advantage of the new favourable regime for vulnerable trusts and who are taken out of the Self Assessment system by the standard rate band.

## Summary

**2.32** It is clear that there is a good deal of scope to modernise the tax system for trusts, and a good deal of consensus that this is a positive thing to do. Many of the ideas in the Inland Revenue consultation papers have been warmly welcomed by respondents, though some ideas clearly require more work and analysis before Ministers decide whether and, if so, how to take them forward.

**2.33** The two areas which are being taken forward at this time will benefit the trusts that have been most affected by the increase in the RAT. The remaining proposals will simplify the administration of the taxation of trusts when they are introduced.

**2.34** Comments on the possible administrative costs or savings to trustees or others as a result of introducing the special regime for trusts for the vulnerable and the standard rate band are welcome.

## Contact Point

Andrew Hayward  
Revenue Trusts  
Room G49  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2755

E-mail: [Andrew.Hayward@ir.gsi.gov.uk](mailto:Andrew.Hayward@ir.gsi.gov.uk)

## REGULATORY IMPACT ASSESSMENT

### Modernising the Tax System for Trusts

### Statement of Ministerial Approval

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

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General  
Dated: 2 March 2005



# 3

## REGULATORY IMPACT ASSESSMENT FOR GIFT AID AND ADMISSIONS

### Purpose and Intended Effects of the Measure

#### *The Policy Objectives*

- 3.1** To remove the scope in the Gift Aid rules for admission fees to view the work of a certain charities simply to be rebadged as donations on which Gift Aid can be claimed.
- 3.2** The intention is to amend the existing exemption so that Gift Aid will apply where the visitor makes a donation, rather than simply paying the normal admission fee.
- 3.3** The secondary objective of this measure is to address unfairness in the current application of the exemption by extending the scope to cover charities which allow the public to pay to view the work they do, not just charities established wholly or mainly for the purposes of the preserving heritage property or the conservation of wildlife.

#### *Background*

- 3.4** The Gift Aid rules, as amended by legislation in 2000, enable individuals who are taxpayers to make a gift to charity, and have those donations treated as made after the deduction of income tax at the basic rate. As charities are exempt from tax on that income, the charities concerned are entitled to reclaim amounts equal to the basic rate of tax paid by the donor on the donations. This means that charities benefit from an additional 28.2 pence for every pound given. The donor must have paid enough income tax or capital gains tax to cover the amount repaid to the charity, and must make it clear to the charity that they want Gift Aid to apply.
- 3.5** Gift Aid will apply when the donor has received no benefits in consequence of the gift, or has received small benefits within specified limits. For gifts of up to £100 a donor can receive benefits worth 25 per cent of the gift, between £100 and £1000, benefits worth up to £25, and for gifts over £1000 the benefit is restricted to 2.5 per cent of the value of the donation. There is a maximum benefit of £250 in any year.
- 3.6** There is, however, an exception to this rule. Certain charities can disregard a right of admission to view the work of a charity in return for a donation when determining the level of benefits received by donors. This exemption is currently only available to charities established for the preservation of heritage property and conservation of wildlife. Without the exemption these charities would not be able to claim Gift Aid where they give a right of admission to view the work of the charity in return for a donation because the benefit of the right of admission would in most cases exceed the Gift Aid benefit rules.
- 3.7** These charities rely heavily on visitor donations. When the exemption was originally introduced it applied to charitable Deeds of Covenant which covered a period of at least three years and meant charities could allow their committed donors to view their work without the tax relief on the donations being affected. With the changes to Gift Aid in 2000, tax relief applied to donations of any amount and the separate tax relief for payments made under a Deed of Covenant was withdrawn, with all relief being given through Gift Aid.

**3.8** The intention of the Gift Aid changes was to encourage people to give more to charity. The exemption available to heritage and conservation charities was incorporated into the new Gift Aid legislation, but an unintended consequence was to allow these charities to disregard the right of admission as a benefit where someone donated an amount equivalent to the normal admission charge.

### *The Risks Being Addressed*

**3.9** Action is required to amend the exemption because charities established for preservation of heritage and conservation of wildlife purposes are increasingly re-badging admission fees as donations in order to benefit from Gift Aid. The person making a donation pays no more than they would otherwise have to pay in order to gain admission and the charity is able to increase its income by 28 per cent. This action, though allowable under the current legislation, is outside the spirit and purpose of the Gift Aid rules, which were introduced with the intention of encouraging additional donations to charity.

**3.10** It is estimated that heritage and conservation charities benefit from tax repayments of £10 million per annum under the Gift Aid scheme as a result of re-badging admission fees as donations, but this action does not generate any additional giving from the person making the payment.

**3.11** It is also appropriate to remove the unfairness in the current exemption in the Gift Aid rules, which applies only to charities established for the preservation of heritage property and the conservation of wildlife. This restriction not only prevents other types of charities that allow the public to pay to view their work from benefiting, but also prevents some heritage and conservation charities from using the exemption, where their sole or main purpose is something other than to preserve heritage property or conserve wildlife.

## **Options**

### *Do Nothing*

**3.12** Changes to the Gift Aid rules in Finance Act 2000 mean that heritage and conservation charities are acting within the terms of the law by seeking donations that give a right to free day admission. This has become established practice, and guidance produced by the Inland Revenue confirms it is within the terms of the existing Gift Aid legislation.

**3.13** The exemption has provided valuable income to a charitable sector that suffered in recent years through the effects of foot and mouth disease and falling numbers of foreign tourists post 11 September 2001. However, the donations that secure a right to free admission are not voluntary donations. The donor would not gain access to the property without making the donation. They do not generate additional giving to the charities concerned, other than the Government's repayments to them of Gift Aid. The donor must pay only an amount equivalent to the admission fee they would otherwise have to pay.

**3.14** To do nothing would in effect be to accept that Gift Aid could apply to admission fees. This was not the Government's intention in introducing Gift Aid. The costs are likely to continue to rise, with only a narrow range of charities able to benefit.

### ***Abolish the Exemption for Heritage and Conservation Charities***

**3.15** The special exemption in the Gift Aid rules enjoyed by charities whose primary purpose is the preservation of heritage property or the conservation of wildlife is anachronistic. These types of charities are the only ones that can offer benefits to donors that exceed the normal benefit rules and still use Gift Aid. There are many other types of charities that operate as visitor attractions and are unable to disregard the benefit to a donor of a right of admission. They are therefore unable to take advantage of Gift Aid in the same way as the heritage and conservation charities.

**3.16** However, the Government recognises that the money generated from these schemes is an important source of funding for many of the charities involved and that such charities have a unique reliance on securing donations from visitors. Many charities have raised finance to improve facilities on the strength of revenue flows that include Gift Aid on donations that attract a right of free admission. Without this source of income to service debt taken on to improve facilities, some charities may become unviable.

### ***Amend the Exemption for Heritage and Conservation Charities***

**3.17** An amendment of the exemption would refocus Gift Aid on generating additional or committed giving to charities and would clarify the position that Gift Aid is not intended to apply to the payment of admission fees. It would also remove the inequity that prevents charities that are visitor attractions (other than charities whose primary purpose is the preservation of heritage property or the conservation of wildlife) from benefiting from Gift Aid where the donor gets a right of free admission.

**3.18** The amended exemption would operate where:

- a right of admission given in return for the gift is valid for a period of at least one year, at all times that the general public can gain admission and the number of visits within this twelve-month period is not restricted, or
- the right of admission is for less than one year; the gift must be at least 10 per cent more than the amount that any member of the public would have to pay to gain the same right of admission.

**3.19** The amendment would also remove the unfairness of the restriction on the types of charity able to benefit from the exemption. Currently, the exemption applies where the sole or main object of the charity is to preserve heritage property or conserve wildlife for the benefit of the public.

**3.20** Amending the exemption so that it applies where a right of admission is granted to view specified types of property preserved, maintained, kept or created by a charity in pursuance of its charitable purposes would ensure the exemption is available to a much wider range of charities. The fact that the property must be preserved, maintained, kept or created 'in pursuance of its charitable purposes' will ensure that commercial activities run solely to raise funds would not be eligible. For example, an amusement park in the grounds of a museum would not be eligible. Loan exhibitions and reciprocal agreements with other charities will benefit from the exemption.

**3.21** The types of property to which the exemption may apply will include in particular buildings, grounds or other land, plants, animals, works of art, artefacts and property of a scientific nature.

**3.22** Amending the exemption in this way may result in a reduction in the income of some charities, but it is believed that this will be relatively small and will be offset by the benefits being extended to a broader range of charities. Overall we expect the measure to be cost neutral to the Exchequer. Representatives from the charity sector have been consulted in the development of these changes and, in their judgement, the proposed amendments would allow charities to encourage a proportion of visitors to make Gift Aid donations rather than simply pay the (lower) admission charge and so some income from Gift Aid on admissions will be maintained.

### **Business Sectors Affected**

**3.23** Charities.

### **Issues of Equity and Fairness**

**3.24** The measure will address two inequities. The first is that certain charities have in effect been able to claim Gift Aid on admission fees, a purpose for which Gift Aid was not intended. The second is that the ability to do so has been available only to charities whose prime purpose is the preservation of heritage property or the conservation of wildlife. This restriction does not recognise the full diversity of charities that generate income from operating as visitor attractions.

### **Benefits**

#### ***Economic***

#### ***Do Nothing***

**3.25** Estimates suggest that the cost to the Exchequer and conversely the yield for charities will continue to increase from its current level of approximately £10 million per annum to perhaps £20 million. This will be caused by more charities becoming aware that they can offer such schemes and individual donors becoming more aware of the opportunities to use Gift Aid.

#### ***Amend Exemption***

**3.26** Changing the Gift Aid criteria for donations in lieu of paying an admission fee could in principle generate additional giving. We do not have any evidence to gauge how many current visitors would be willing to make the additional donation as opposed to paying a lower entrance fee.

**3.27** However, charity representatives have said in discussion that a donation that is 10 per cent more than the normal admission fee is at a level that should ensure a reasonable proportion of visitors opt to make the donation rather than pay the admission charge. And the amendment safeguards the Gift Aid position for most annual membership schemes so Gift Aid income from that source will be maintained.

**3.28** Extending the exemption so that a broader range of charitable activities is covered would also have a positive financial effect on charities that do not currently benefit from the exemption.

### ***Social***

**3.29** There are some charities that are currently not able to benefit from the exemption that provide a clear social benefit. They may for example run facilities for which they charge an admission and which are designed to benefit the disabled by providing employment. Currently these charities are unable to benefit from the exemption because their primary purpose is to help the disabled.

**3.30** Expansion of the current exemption beyond charities whose primary purpose is the preservation of heritage property or the conservation of wildlife will ensure that these facilities would be able to benefit in future from an amended exemption. It is not possible to quantify the number of charities that are in this position, or the benefit to them of expanding the exemption.

### ***Environmental***

**3.31** Charities established for the preservation of heritage property or the conservation of wildlife contribute directly to the good maintenance of the natural and built environment. The ability to disregard a right of admission to a donor to view the work of the charity, given in return for a donation, has enabled these charities to increase their income by around £10 million per annum. This additional £10 million per annum has a direct impact on the amount of environmental work charities can conduct.

**3.32** Extensions of the exemption to buildings, grounds, land, animals and plants is more inclusive and will enable charities that benefit the environment, but do not come within the narrow definition of the current exemption, to invest more funds into protecting the natural and built environment.

### ***Costs***

#### ***Economic***

#### ***Do Nothing***

**3.33** Seeking Gift Aid donations in return for a right of admission to view the work of the charity is not compulsory, so charities are in a position to determine whether the benefits outweigh the costs in these circumstances. There is currently a small compliance cost for charities in terms of explaining to potential donors the benefits of giving a donation rather than paying for admission. These costs are likely to be negligible.

#### ***Abolish Exemption***

**3.34** The existing exemption benefits charities by an estimated £10 million per annum in Gift Aid repayments from the Exchequer. Abolition of the exemption would eliminate charities' compliance costs associated with administering the exemption but would remove an income stream from some charities which may affect plans for investment and development in the heritage property and wildlife charity sectors. It is not possible to quantify this reduction, as it is dependent upon other factors such as the ability of charities to make administrative cost savings.

### *Amend Exemption*

**3.35** The cost to charities will depend on the extent to which visitors are willing to make a donation compared to the alternative of a lower entrance fee. While we cannot predict in advance how many visitors would be willing to make such a higher level of donation, charity representatives have indicated that they are prepared to make the effort necessary to engage visitors and encourage them to make a Gift Aid donation and are confident that a significant proportion will do so.

**3.36** On the basis that around 70 per cent of donors who take advantage of the current exemption in the Gift Aid rules would pay the higher donation, charities would be no worse off in terms of their total revenue from visitors, whether from admission fees or Gift Aid donations and tax claimed on those donations. If the numbers willing to make the higher donation were only between 30 per cent and 50 per cent, then the affected charities could face a revenue shortfall from entrance fees and donations of between 6 per cent and 12 per cent. The cost to the Exchequer of extending the relief is estimated to be negligible.

**3.37** It is envisaged that the compliance costs associated with charities administering an amended exemption will be no greater in the long term than those associated with the existing exemption, but there may be some small up front costs associated with the move to an amended exemption.

**3.38** Heritage and conservation charities that are already making use of Gift Aid may incur costs to change their ticketing systems, pricing structures and marketing materials. Charities may need to amend or produce marketing literature to inform individuals visiting the charity of the choice to pay an admission fee or make a donation. There is also likely to be some training requirement for employees or volunteers in order to ensure they can properly deal with donations given under the exemption.

**3.39** Finally, there may be a requirement for minor changes required to IT or accounting systems to enable charities to comply with the requirements of the exemption. There is also likely to be a small additional compliance cost as charities get to grips with the new rules. Overall these costs are expected to be negligible and changes will not take effect until April 2006 so charities have some time to plan and introduce the necessary changes to a timetable that suits the organisation.

**3.40** Any changes to the exemption will not significantly affect the VAT position. The part of the donation equal to the admission charge is currently subject to VAT and this will continue if the scheme is amended. Broadly, this will enable charities to reclaim VAT on inputs. The additional 10 per cent in excess of the admission price will qualify as a donation and therefore it will not be subject to VAT.

**3.41** Before the proposed Gift Aid change the charity would have been required to identify the admission charge and account for VAT in the correct manner - the change will not alter that position so will not increase compliance costs from a VAT perspective.

### *Social*

**3.42** If the exemption is not broadened then charities whose primary charitable purpose is social, rather than being the preservation of heritage property or conservation of wildlife will remain outside the exemption. Ultimately this will have no effect on their income as these charities are not currently able to benefit from the

exemption, but there is an opportunity cost i.e. it would prevent such charities investing additional funds for charitable social purposes.

### ***Environmental***

**3.43** Charities whose primary purpose is the preservation of heritage property or the conservation of wildlife may have less income to invest in their charitable purposes under a revised exemption. The ability of charities to maintain the same levels of income from the exemption is dependent upon how successfully the charity markets the revised exemption. Charities will need to attract 70 per cent of those currently using the exemption to give 10 per cent more than they would otherwise have to pay to gain admission in order to maintain their current levels of income.

**3.44** If the exemption were to be abolished then heritage and conservation charities would lose approximately £10 million per annum. This would directly impact the levels of money charities could invest in environmental projects.

### **Small Business Impacts**

**3.45** Many charities operating as visitor attractions will be small businesses. Their size and income mean that it is likely they represent less than half of the income derived from Gift Aid in these circumstances, though we do not have evidence to substantiate this. The impacts on small businesses are not discrete from those of the charity sector as a whole and are covered elsewhere in this Assessment. Overall the impact on small businesses is likely to be negligible.

### **Competition Assessment**

**3.46** The principal effect of this measure is on the tourism and recreational services sector. Enabling certain charities to attract Gift Aid donations on admissions puts them at a commercial advantage to other visitor attractions including other charities that cannot benefit for the exemption.

**3.47** Amending the exemption so that the donor has to make a conscious decision to give a donation that is more expensive than simply paying an admission fee will ensure that Gift Aid is not in effect simply being claimed on admission fees, but is the result of a genuine donation.

**3.48** Extending the scope of the relief will remove the commercial disadvantage suffered by charitable visitor attractions whose primary purpose is other than the preservation of heritage property or the conservation of wildlife.

### **Securing Compliance**

**3.49** There will be no new compliance requirements as a result of this measure. Charities are subject to periodic audits of their Gift Aid claims and are required to maintain records sufficient to enable Inland Revenue to confirm that the claims are correct.

### **Consultation**

**3.50** Following the initial announcement in PBR 2003 that the Government intended to change the exemption which allowed charities to grant free day admission in return for a donation on which Gift Aid can be claimed, the Inland Revenue sought views from

the charity sector and met a range of individual charities and charity representative bodies to discuss the effect of the proposals. A further period of consultation was held after the Budget in 2004 during which the proposals were tailored to meet the concerns of the charity sector and draft legislation based upon those discussions has been shared with the sector.

### Monitoring and Evaluation

**3.51** Gift Aid claims from charities using the exemption are not differentiated from other Gift Aid claims, so there is no simple mechanism available to establish the effect of the measure. In order to evaluate the effect of this measure we will instead conduct a survey of charities during 2007.

### Summary and Recommendation

**3.52** The current exemption for heritage and conservation charities no longer achieves the results it was intended to. Nevertheless, the Government recognises that it provides a valuable income stream for charities that rely on visitors to fund their work. It is therefore the Government's intention to amend the current exemption.

**3.53** There are two main drivers for amend the exemption. The first is to refocus the exemption in line with the general principles of Gift Aid, which was introduced with the intention of encouraging additional donations to charity. The way in which the exemption is currently being operated merely re-badges admission fees as donations and this action does not generate any additional giving from the person making the payment.

**3.54** The charity sector has also moved on since the exemption was first introduced and the types of charities generating income from visitors to their property are much more diverse. It is therefore necessary to ensure that the discrimination in the current exemption, which restricts the beneficiaries of the exemption to charities established for the preservation of heritage property and the conservation of wildlife is removed.

### Contact Point

Adrian Cooper  
Revenue Charities  
Room Gc22  
1 Parliament Street  
London  
SW1A 2BQ  
  
Tel: 020 7147 2782  
E-mail: [Adrian.Cooper@ir.gsi.gov.uk](mailto:Adrian.Cooper@ir.gsi.gov.uk)

---

**REGULATORY IMPACT ASSESSMENT**

**Gift Aid and Admissions**

**Statement of Ministerial Approval**

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

Signed by the responsible Minister:

John Healey  
Economic Secretary to the Treasury

Dated: 8 March 2005



# 4

## REGULATORY IMPACT ASSESSMENT FOR SHARI'A COMPLIANT FINANCIAL PRODUCTS

### Introduction

**4.1** This final regulatory impact assessment considers the costs and benefits of options for addressing the tax treatment of Shari'a compliant financial products. It accompanies the announcement of legislation in Budget 2005 to amend certain rules for income tax, corporation tax, capital gains tax and stamp duty land tax (SDLT). The legislation was developed in consultation with a wide range of interested parties.

### Purpose and Intended Effects of the Measure

#### *The Policy Objectives*

**4.2** The objective is to ensure that Shari'a compliant financial products are taxed in a way that is neither more nor less advantageous than equivalent banking products. The intended effect of the proposals is to allow providers to offer Shari'a compliant products without facing commercial disadvantage, and to enable customers to take up these products without encountering uncertainty or disadvantage over tax treatment.

**4.3** There are around 1.8 to 2 million Muslims permanently resident in the UK. Shari'a compliant finance is an important part of life for this faith group and the UK is committed to removing discrimination and unfair impediments. Shari'a compliant financial products are available to both Muslims and non-Muslims, so all consumers should have the opportunity to take up these products without facing undue tax barriers. The tax proposals for Shari'a compliant products apply equally regardless of the faith of provider or customer.

#### *Background*

**4.4** Shari'a law prohibits transactions that involve interest, gambling, speculation or unethical investment. The most pronounced difference between Islamic financing and existing equivalent products is the prohibition on interest. This is based on the view that it is unacceptable in and of itself for money to increase in value merely by being lent to another person.

**4.5** For customers who want to adhere to Shari'a law, this rules out financial products that result in either payment or receipt of interest, such as conventional deposit accounts and loans. However, Shari'a law does not prohibit the making of a return on capital if the provider of the capital is willing to share in the risks of a productive enterprise. Thus profit and loss sharing arrangements are considered acceptable, provided there is risk sharing.

**4.6** Islamic financial transactions are structured using contracts, or combinations of contracts that satisfy the requirements of Shari'a law. Some of the most common are as follows:

- Mudaraba financing, a partnership structure, consisting of one or more partners that contribute capital and a managing partner who contributes knowledge and expertise. The managing partner receives a fee for services provided. The manner in which profits are to be distributed must be pre-determined.

- Murabaha sometimes referred to as mark-up or cost plus financing. The financial institution purchases the goods for the customer and re-sells them to the customer on a deferred basis, adding an agreed profit margin. The customer then pays the sale price for the goods either in instalments or one lump sum at the end of the period.
- Ijara, the Islamic equivalent of a conventional lease. There are several variations on this structure.

**4.7** Financial institutions in the UK are now offering Shari'a compliant products that are economically equivalent to conventional banking products but do not involve interest or speculative returns. The first Shari'a compliant mortgage product in the UK was offered in 1997. Before legislation in 2003 to remove the double payment of stamp duty land tax on such products, however, the size of the market was limited and there were no other providers.

**4.8** In recent years there have been a number of prominent developments in the UK Islamic finance market, and there is now considerable interest in developing and marketing a wide range of products. Shari'a compliant current accounts, savings accounts, and house purchase facilities are now available. All deposit takers must be authorised and regulated by the Financial Services Authority (FSA).

**4.9** The tax treatment of Shari'a compliant financial products is in some areas uncertain and in others produces anomalous results. These anomalies can put providers of Shari'a compliant products at a commercial disadvantage. Customers may also suffer a disadvantage if financial institutions have to charge proportionately more for Shari'a compliant products.

**4.10** In 2003, reforms to modernise SDLT included two reliefs for Alternative Property Finance. These reliefs are used by providers and users of Shari'a compliant financial products who wish to structure property finance so as to avoid the payment or receipt of interest. To achieve this end, Shari'a compliant property finance products had been developed, but they involve a series of chargeable land transactions that are not necessary under conventional mortgage structures. It was these additional land transactions that the Government sought to relieve from SDLT.

**4.11** This legislation removed the possible double imposition of SDLT on a house purchased using two Shari'a compliant financial products. Legislation was not tied to the Qu'ran or the Islamic faith, but used intrinsic features of the underlying contracts under UK law to define the transactions to which the rules apply. Reaction from the Muslim community to the reliefs has been positive and the legislation is being reviewed in light of further developments and growth in the Shari'a compliant finance market.

### **The Risks Being Addressed**

**4.12** A number of issues have emerged concerning income tax and corporation tax. For example, where a Shari'a compliant savings account operates under a Mudaraba contract, the return to the customer is initially based on a pre-determined division of profits. As such, under current UK tax law the return is treated in the same way as a dividend from a UK company and needs to be included in the customer's income tax return as such.

**4.13** The financial institution would be unable to treat the payment as a deduction for corporation tax purposes. Since the tax treatment of the bank in some cases depends on the tax position of the customer, it can be difficult for the bank to comply with its tax reporting obligations.

**4.14** The customer's tax position can also be quite different to that of a customer with a savings account in a conventional bank. For example, there would be no tax deducted at source that non-taxpayers and taxpayers due to pay tax at the lower rate (10 per cent) could reclaim (tax is deducted at source from savings income at 20 per cent). Customers could also have problems in filling in their tax return.

**4.15** Tax problems also occur in the finance of business asset purchases. Under a Murabaha contract, the financial institution purchases the asset for the customer and re-sells to the customer, adding an agreed profit margin. As the institution adds a profit margin rather than charging interest on a loan, the customer may be unable to get full tax relief for the cost of buying the asset.

**4.16** With regard to stamp duty land tax, there are currently two reliefs that relate to Shari'a compliant products, which were introduced in 2003. The first relief relates to Ijara products. The relief allows financial institutions to buy property and then lease it to the individual who pays rent and simultaneously makes capital repayments. The property passes to the individual at the end of the agreement. Without relief this product would incur stamp duty land tax twice and potentially lease duty. There is also a relief for Murabaha products. This allows financial institutions to buy property and then sell it on immediately to an individual at a higher price. The financial institution then accepts deferred payments of the purchase price.

**4.17** Since 2003, there has been significant growth and development in the Islamic finance market with the result that some problems not envisaged at this time have since emerged. In particular the relief for Ijara products is currently difficult to use in Scotland. In Scotland residential leases are limited to a maximum of 20 years, but standard securities (the equivalent of mortgages) are generally 25 years or more. For Ijara products it is necessary for there to be a lease for the entire period of the arrangement, which needs to be 25 years to make it equivalent to a standard mortgage.

**4.18** In Scotland there are 43,000 Muslims of whom approximately 65 per cent are homeowners. This group has hitherto not had access to Shari'a compliant mortgages. Offering Shari'a compliant mortgages, which incur the same level of stamp duty land tax, will offer Muslims and others in Scotland a greater degree of choice and flexibility.

**4.19** A further problem exists with a product known as Diminishing Musharaka, a subset of Ijara. With a Diminishing Musharaka product, beneficial ownership is explicitly transferred to the individual during the term of the lease. This means it falls outside the scope of the existing relief, which required the financial institution to hold the 'interest' in the property until it finally reverts to the individual.

**4.20** Extending the relief to this product will further enhance the capability of providers of Shari'a compliant financial products to offer a wider range of choice to consumers. Consumers in turn will be better placed to find a product that meets their needs.

**4.21** Regulation of financial services is important in providing consumer protection and an orderly market. Clarification of tax treatment and the removal of tax disadvantages should encourage product development within the UK regulated sector.

## Options

### *Do Nothing*

**4.22** This would not address the potential unfairness and uncertainty outlined above, and would not encourage the provision of Shari'a compliant financial products by the regulated market. There is a risk that if no action is taken, such products might develop in an unregulated market.

### *Extra Statutory Concession*

**4.23** An Extra Statutory Concession (ESC) could potentially address the problem in the short-term by alleviating the clearest anomalies whilst permanent solutions are developed in legislation. This allows more time to develop long-term solutions in what is still a fast developing area. However, this would provide only a temporary solution and could not address areas where current tax treatment might have conferred an advantage for one party on Shari'a products. It would not offer a structural solution capable of giving a clear framework for the future development of new products.

### *Legislative Solutions*

**4.24** After internal analysis and consultation, the preferred way forward is to recommend a legislative solution. However, the precise form of the legislation requires careful consideration to fit with existing tax law for financial products and the UK's responsibilities under its network of taxation treaties. In consultation it emerged that it would not be possible to address all tax issues affecting the development of Shari'a compliant products with a single piece of legislation. Therefore it was agreed to establish a forum to evaluate progress achieved and continue to work towards solutions on outstanding issues after Finance Bill 2005.

## Business Sectors Affected

### *Financial Institutions*

**4.25** The pace of market developments in the UK since the legislation on SDLT in 2003 suggests that a large number of financial institutions will be interested in developing a range of Shari'a compliant products once greater clarity is brought to the question of tax treatment, and will benefit from enhanced flexibility in development and marketing.

### *Small Businesses*

**4.26** Initially, most of the Shari'a compliant products currently in development will be geared towards retail customers. However, Shari'a compliant business products are already being developed, and banks have shown interest in expanding into this area. Over time a significant proportion of the customer base for providers of Shari'a compliant financial products is likely to be Muslim run small businesses who wish to comply as far as possible with the provisions of Shari'a law. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

## Issues of Equity and Fairness

**4.27** The proposal seeks to address an existing inequality in the tax treatment of Shari'a compliant financial products, and to promote fairness by contributing to the Government's financial exclusion and asset saving objectives.

**4.28** The Government is committed to working together with financial services providers to achieve a reduction in the one in twelve households in the UK who lack access to a bank account of any kind. Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and loans.

**4.29** The Government is also seeking, through measures such as the Saving Gateway and Child Trust Fund, to provide targeted support and incentives for saving. Evidence suggests that on average British Muslims have less access to and uptake of financial services than the majority of the population. Part of the reason for this may be the lack of provision of Shari'a compliant products.

**4.30** Applying the tax law as it currently stands would leave in place a real inequality since the tax treatment would not always reflect the economic purpose of the transactions. For example, Islamic banks may be at a commercial disadvantage to conventional banks in that they cannot always deduct the cost to them of obtaining funds against the profit that they make from providing funds to their customers.

**4.31** Customers could suffer if providers have to charge proportionately more for their products than conventional banks, although some may be better off overall if in some circumstances they would pay less tax on the equivalent product from a conventional bank.

**4.32** There are close links between providers of Shari'a compliant financial products and the ethical investment market. Many of the concerns of this customer base are mirrored in the concerns of banks' Shari'a supervisory committees, for example the prohibition of investment in alcohol, tobacco, gambling, or financial institutions dealing in interest. Investment markets benefit from growth in liquidity and transparency.

**4.33** Moves towards removing possibly disadvantageous tax treatment for Shari'a compliant products will extend product flexibility and consumer choice. They may also have the effect of encouraging investment in banks advertising themselves as ethical.

## Benefits

### *Economic*

### *Do Nothing*

**4.34** No real economic benefits could be expected from applying existing tax law to new Shari'a compliant products. There could be a real risk of customers turning to products developed outside the UK, or to products developed outside the regulated sector, and continued tax uncertainty would be likely to hinder further product development and innovation.

### ***Extra-Statutory Concession***

**4.35** This would have offered a short-term benefit by allowing current businesses to go ahead on an agreed basis, but does not offer a long-term stable platform for development.

### ***Legislative Solution***

**4.36** The clarification of tax rules has the potential to encourage development of Shari'a compliant financial products within the UK. This should in turn generate investment, jobs and tax revenues in the UK economy. The emergence of a thriving and competitive market in Islamic finance products could substantially benefit London as a global financial centre.

**4.37** Some customers for these products may at present be in an uncertain position over their tax position, and others may find themselves in an untaxed environment. Legislative changes would put everyone on an equal footing.

**4.38** The primary policy objective is to remove an existing inequality that derives from the inapplicability of existing legislation to the taxation of Shari'a compliant financial products, and to offer genuine choice to consumers wishing to take up these products. The Exchequer effect in the short term is expected to be minimal, but potentially positive in the long-term if more institutions offer such products, if the existing product range is expanded, and if the customer base continues to expand.

### ***Social***

#### ***Do Nothing***

**4.39** It is unlikely there would be any social benefits from this course of action.

#### ***Extra Statutory Concession***

**4.40** An ESC could provide a limited social benefit by allowing one bank to offer Shari'a compliant products in the short-term without tax disadvantage, thus potentially widening financial access for the bank's customer base. However, since the measure would have been very limited, it is unlikely that it would contribute significantly towards longer term social issues.

#### ***Legislation***

**4.41** Continued difficulties with the development of Shari'a compliant products has the potential to cause difficulty and frustration for the UK Muslim community. There are clear social benefits in the wide availability of well-defined, well-regulated financial products in all sections of the community.

**4.42** It is reasonable to expect that the development of a regulated Islamic financial sector in the UK would bring in financial transactions that may currently be taking place without any significant regulation or consumer protection.

#### ***Environmental***

**4.43** None of the options are expected to have any significant environmental impact.

## Costs

### *Economic*

#### *Do Nothing*

**4.44** There would be continued economic cost from this option. Financial institutions offering Shari'a compliant products would have to operate at a commercial disadvantage with the result that profits may be affected. Without the removal of existing uncertainties over the tax treatment of Shari'a compliant financial products, it is unlikely that there would be a great deal of incentive in offering them amongst high street financial institutions.

#### *Extra Statutory Concession*

**4.45** An ESC might allow institutions offering Shari'a compliant financial products to operate profitably in the short-term but would not remove uncertainty in the longer-term.

**4.46** As a concession, it could apply only to the party to the transaction who was disadvantaged by it. An ESC cannot impose a tax charge on a party who was better off. This could have opened up scope for avoidance by parties setting up deals to take advantage of this mismatch.

### *Legislation*

**4.47** It is unlikely that legislation will have a significant negative Exchequer impact.

**4.48** For example, with regard to the changes to SDLT, Muslim homeowners in Scotland have been paying SDLT normally on house purchases. Offering Shari'a compliant mortgages which do not give rise to a different level of SDLT will not result in any significant change in revenue. Similarly, the cost of extending the relief to the Diminishing Musharaka product should be nil for the same reasons.

**4.49** Legislation will not be tied to the Qu'ran or the Islamic faith, but rather use intrinsic features of the underlying contracts under UK law to define transactions to which the rules will apply. As always, the possibility of abuse has to be considered. The legislation will therefore contain safeguards to prevent it being used for avoidance.

**4.50** There is some operational impact on the Inland Revenue, who will have to ensure that systems for monitoring, reporting and auditing the deduction of tax at source are able to cope with these financial products. Tailor-made guidance, forms and letters will also be needed. However, it is not anticipated that the impact and cost will be substantial.

### *Social*

#### *Do Nothing*

**4.51** Failure to act would unfairly inhibit the activities of providers of Shari'a compliant financial products. It is unlikely that these products will be widely offered if the existing tax uncertainties are not addressed, with the result that any possible contribution towards financial inclusion and savings and asset objectives would be very limited. Informal provision of finance may continue on a similar scale as before.

### ***Extra Statutory Concession***

**4.52** This option would demonstrate the Government's serious consideration of the issues, but since longer-term uncertainties would remain, the social benefits in terms of greater inclusion and/or asset ownership are likely to be limited.

### ***Legislation***

**4.53** The social costs of legislating to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products are minimal. The main risk is that the legislation will not address 100 per cent of the tax issues for 100 per cent of the products offered, so that some uncertainties (and the need for ongoing legislation in the future) remain.

### ***Environmental***

**4.54** None of the options are expected to result in significant environmental costs.

### ***Small Business Impacts***

**4.55** The current focus of existing Shari'a compliant financial products is the retail market (retail mortgages, personal loans, current and savings accounts etc.). However, research suggests there are a very large number of Muslim small businesses in the UK with a potential demand for Shari'a compliant business products. Successful trials of these products, together with the Government's commitment to legislate to remove inequality and uncertainty, could well lead to the development of a range of products geared towards small businesses. Such products would allow them to reconcile faith commitments with more secure access to finance.

### ***Competition***

**4.56** A competition assessment has been undertaken and the competition filter indicated that legislation to address current uncertainty and inequality in the tax treatment of Shari'a compliant financial products should not have any significant adverse effects on the competitive processes in the financial services market.

**4.57** The major affected market will be the banking sector – both those institutions offering solely Shari'a compliant financial products and high street banks with an interest in offering such products alongside (albeit ring-fenced from conventional investments) conventional banking products. A number of other providers offer or are planning to offer alternative property finance products. There are also private membership organisations, which offer interest-free loans (financed by membership fees) and housing finance.

**4.58** In terms of competition, do nothing would have had no obvious positive consequences. Given the uncertainties and commercial disadvantages that would remain for providers of Shari'a compliant financial products, this option could have negative competitive consequences by restricting the profitability of offering such products, perhaps enabling only those banks willing to fund Shari'a compliant operations from other areas to compete in the marketplace.

**4.59** Extra statutory concession would have some competition enhancing effects by allowing providers of Shari'a compliant products to offer them without tax disadvantage. But given that long-term uncertainty would not be removed, it is unlikely

that there would be much interest amongst other potential providers to offer these products. The effect of this option might therefore have been to restrict competition.

**4.60** Legislation could have significant positive consequences for competition. If legislation to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products is successfully introduced, it is likely that there will be considerable interest amongst other financial institutions, both mainstream and those offering solely Shari'a compliant products. Customers (not necessarily Muslims alone) will be offered a greater degree of choice since they should not have to pay disproportionately more for Shari'a compliant than for conventional banking products.

**4.61** The overall effect should therefore be to encourage an expansion of both the range of financial products available and the number of institutions willing to offer them.

## **Securing Compliance**

### ***Do Nothing***

**4.62** There could be continuing compliance difficulties as the banks may have difficulties in meeting their reporting requirements because of the uncertain tax position of their customers.

### ***Extra Statutory Concession***

**4.63** An ESC could only enable the tax position of the disadvantaged party to be addressed. Some transactions might result in one party being advantaged, leaving scope to avoid potential asymmetries.

### ***Legislation***

**4.64** Legislation should provide a clear framework for providers to meet their reporting requirements and should therefore have a beneficial impact on compliance. The legislation will apply the reporting obligations and compliance provisions that apply to the tax deduction scheme for bank and building society interest.

## **Review, Monitoring and Evaluation**

**4.65** Finance Bill 2005 legislation on Shari'a compliant financial products will build on the measures taken in Finance Bill 2003 on stamp duty land tax and is expected to make a significant contribution to the facilitation of product development and the extension of consumer choice. Given the complexity of some of the issues involved, and the dynamic nature of the market in Shari'a products, it is proposed to establish a longer term review mechanism to analyse the effectiveness of this legislation and monitor market developments.

**4.66** Measures announced in this Budget address potential problems in the tax treatment of Shari'a compliant products relating to the rules for income tax, corporation tax, and stamp duty land tax. Complications with other taxes, for example VAT, may arise in the future. This could lead to problems in financing purchase of products such as cars and/or business properties (on which VAT is chargeable). Because VAT is a European tax, a solution is likely to take longer and may have to be found at the EU level.

**4.67** There are currently two broad types of Shari'a compliant home purchase arrangements available in the UK: Murabaha and Ijara. On 31 October 2004, the Financial Services Authority (FSA) assumed responsibility for the regulation of mortgages, including mortgage backed equity release products and Murabaha. However, neither home reversion plans nor Ijara products fall within the framework of financial services set out by the Financial Services and Markets Act 2000 (FSMA) and are therefore not within the scope of FSA regulation.

**4.68** The Government recently consulted on whether Ijara products should be included in the legislation to bring home reversion products into FSA regulation and the majority of respondents agreed that they should. Legislation to bring Home Reversion schemes into the scope of FSA regulation will be brought forward as soon as Parliamentary time allows.

**4.69** The market in Shari'a compliant financial products is extremely dynamic, with the result that, providing the Financial Services Authority (FSA) gives approval, a range of new products are likely to be offered in the UK marketplace over the next few years. Given that legislation can only apply to the underlying contract in each transaction, some products (if they involve new forms of contract) will require legislation to remove inequality or uncertainty in tax treatment.

**4.70** A review mechanism has been established to identify: the extent to which legislation has or has not succeeded in its objectives; the uptake of Shari'a compliant financial products by UK Muslims and other interested parties; remaining discrepancies in the tax treatment of these products; and the development of new Shari'a compliant financial products. Contact details will be made available for interested parties to express their views and request information.

## Consultation

**4.71** A process of informal consultation with providers and users of Shari'a compliant financial products and a wide range of interested parties, including representatives of the accounting, legal and banking professions, as well as a number of UK Muslim organisations, is ongoing.

**4.72** A consultation seminar to discuss Shari'a compliant products in relation to tax issues was held at HM Treasury in January. This was well attended and provided a useful platform for further contact with interested parties. Following the outcome of this meeting, a number of technical expert groups have been formed. These will continue to meet to monitor progress and outstanding issues.

## Contact Point

Robin Newnham  
Corporate Taxation  
2/E1  
1 Horseguards Road  
London  
SW1A 2HQ

Tel: 020 7270 6105

E-mail: [Robin.Newnham@hm-treasury.gsi.gov.uk](mailto:Robin.Newnham@hm-treasury.gsi.gov.uk)

---

**REGULATORY IMPACT ASSESSMENT**  
**Shari'a Compliant Financial Products**  
**Statement of Ministerial Approval**

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

Signed by the responsible Minister:

Stephen Timms  
Financial Secretary to the Treasury

Dated: 8 March 2005



# 5

## REGULATORY IMPACT ASSESSMENT FOR EUROPEAN COMPANY STATUTE

### Purpose and Intended Effect of the Measure

#### *The Policy Objectives*

**5.1** This regulatory impact assessment considers the direct tax changes resulting from the implementation of the EU regulation on the European Company. It has been possible to form a European Company since October 2004. A Technical Note and draft clauses detailing changes to UK tax law, that will give UK companies tax certainty if they form or operate a European company, was published 19th January 2005. The clauses mean the European Company will be taxed on a similar basis to a UK company.

#### *Background*

**5.2** The European Company Statute (ECS) was adopted by the European Council of Ministers on 8 October 2001. The ECS permits the formation of a European Company (referred to in the ECS as the Societas Europaea or SE) and provides for other rules governing SEs. This full Regulatory Impact Assessment (RIA) covers the tax measures that will be required to ensure the successful implementation of the ECS in the UK.

**5.3** The ECS came into effect on 8 October 2004 and permits the formation of an SE by various mechanisms:

- “Transformation”, i.e. the conversion of a UK company (or similar company in another Member State) into an SE;
- formation of a subsidiary SE;
- formation of a parent SE; and
- the merger between two (or more) companies in different Member States into an SE.

**5.4** The ECS relates to company law and does not mention tax. The DTI have issued regulations enabling mergers prescribed by the ECS to form SEs to be possible in UK law.

#### *Interaction with the Mergers Directive and Formation of an SE by Cross Border Merger*

**5.5** For most UK tax purposes, an SE based in the UK will be treated like a UK PLC and will fit within the existing corporation tax regime and other regimes relating to UK companies. The most significant issue for direct tax relates to the fourth bullet - the formation of SEs by cross-border merger. This is governed by the Mergers Directive (90/434/EEC) as the EU Commission proposed that SEs were to be added to the Mergers Directive.

**5.6** The effect of the Mergers Directive will be, broadly, that the formation of an SE by merger should be tax-neutral. To achieve this, some changes to UK tax legislation are needed to ensure that this “fit” is as seamless as possible.

**5.7** Formation of a SE by merger is a new option for business in the UK and the EU. The tax measures to implement the ECS will not have any impact on existing businesses

unless they choose to become a SE. This can therefore be viewed as a deregulatory measure.

**5.8** Although formation by merger is the most significant aspect of the ECS for UK tax legislation, there are other articles of the ECS, which will have some effect on UK tax legislation.

### ***Other Provisions of the ECS***

**5.9** Articles 7 and 8 of the ECS set out rules for the registered office of an SE, and in particular, for the transfer of the registered office of an SE from one member states to another. This provision and the addition of SEs to the Mergers Directive mean that a tax charge should not arise on such a transfer other than those that involve the actual transfer of ownership of assets outside the jurisdiction of the transferor Member State.

**5.10** Articles 9 and 10 of the ECS set out a hierarchy of the rules governing SEs and article 68 provides that member states should make such provision as is appropriate to ensure the effective application of the ECS.

### ***This Regulatory Impact Assessment***

**5.11** This full Regulatory Impact Assessment covers the provisions, which are necessary to accommodate mergers to form SEs in UK tax law

### ***The Risks Being Addressed***

**5.12** This is an enabling measure, allowing companies to benefit from a new form of company organisation permitted by a EU Regulation. So in terms of addressing risks, there are two elements. Firstly, if we did not provide certainty for UK business there would be a risk that UK companies and businesses might operate at a commercial competitive disadvantage to their European rivals.

**5.13** The other risk is that in the absences of any amendments to UK legislation, the new situation created by the ECS potentially may permit some companies to use what should be a commercial decision simply to avoid a tax charge.

### **Options**

**5.14** Consideration of the risks above led us to consider three broad options when developing policy:

#### ***Doing Nothing or the Absolute Minimum***

**5.15** The ECS is a company law measure, not tax legislation. The Government did consider allowing existing tax legislation simply to apply to SEs, as there are existing rules, which could have applied to the main transactions affecting SEs. However, there is not a perfect match between existing tax law and the company law regime introduced by the ECS. Doing nothing may have generated uncertainty and additional compliance costs for business.

#### ***Wait Until the ECS Beds In***

**5.16** The attraction of this option was to see what the take-up of the option to form SEs was in practice. It would also have enabled the Government and business to await the outcome of developments on other proposed EU legislation. The problem with this

option is that if there were tax uncertainty, this would hinder use of SEs, which in turn would feed into take up.

### ***Bespoke Tax Rules for Certain Transactions Affecting SEs***

**5.17** This was the option chosen by the Government. Certain transactions, such as formation by cross-border merger and transfer of registered office, are unprecedented in UK company law. The Government's view is that the design of specific tax rules for these situations would provide certainty for business.

### **Business Sectors Affected**

**5.18** These measures will in general affect larger companies. Public limited companies and the equivalents in other EU Member States will be eligible to form SEs.

### **Issues of Equity and Fairness**

**5.19** Our assessment is the measure does not raise particular issues around the sectors affected or issues of equity or fairness.

### **Benefits**

**5.20** The wider benefits of the ECS in a UK context are discussed in the RIA produced by the DTI in their consultation of October 2003. This RIA is attached as an Annex.

**5.21** The tax changes exposed here mean that the formation of a SE by merger will be tax neutral for any company or SE wishing to take advantage of these provisions. Similarly they will provide a tax neutral environment in the case of a transfer of the registered office of a SE.

**5.22** The changes are also designed to provide companies contemplating forming a SE or SEs themselves with certainty about the tax rules which will apply to transactions involving them. By choosing the option of bespoke legislation the Government has given business certainty, which in turn reduces the cost to business of tax advice in investigating whether an SE might be for them.

### **Costs**

#### ***Policy***

**5.23** There are no direct costs that the policy requires companies to incur. There are indirect costs of dealing with the company law changes brought about by the ECS and of complying with new tax rules.

#### ***Implementation (Compliance)***

**5.24** Since the aim of the continuity provisions is to prevent additional tax costs to companies' forming/becoming SEs, there should be no arising costs to companies. There may be some costs arising from the machinery provisions, but it is expected to be negligible.

### ***Exchequer Effect / Distributional Impacts***

**5.25** The aim of the ECS is to eliminate any tax charge arising on formation of an SE by cross border merger. Since such a mechanism has no previous comparison there is no direct methodology for making an assessment. On the basis that previously a cross border merger of the type the ECS provides for, could have given rise to a tax charge, then we anticipate a very small to negligible cost to the Exchequer.

### ***Small Business Impacts***

**5.26** Although there is nothing intrinsically precluding small businesses from making full use of the ESC, its international scope leads us to an initial assessment that the measure is unlikely to have much if any impact on small businesses.

### ***Other Costs and Benefits (Public and Private Sector)***

**5.27** We do not see any particular infrastructure costs involved in the measure. It will provide a new option for business to conduct re-structuring within a European context and enable UK business to operate on a level playing field with their counterparts elsewhere in the EU.

### ***Unintended Consequences***

**5.28** We do not see any unintended consequences arising from the tax legislation in relation to ECS.

### ***Other Impacts***

**5.29** We see no impact of the ECS tax legislation for human rights, devolution, E-policy, environmental impacts or rural communities.

### ***Competition Assessment***

**5.30** The new tax legislation will affect all markets since formation of a SE is not restricted to any particular sector. In like manner to company tax provisions in relation to the SE, this legislation will not impose additional costs - either set-up or ongoing - on any companies, nor restrict the ability of companies to choose the price, quality, range or location of their products.

**5.31** It is anticipated that the legislation will not affect competition, either positively or negatively. It is possible that the legislation will have an effect on market structure since the formation of SEs by merger could lead to a smaller number of UK registered companies, although this could be off set by non-UK companies migrating into the UK.

### ***Securing Compliance***

**5.32** At present there are number of tax provisions that apply to companies that are engaged in a merger. In essence, provided the merger is undertaken for bona fide commercial reasons then, notwithstanding that otherwise there would have been a taxable disposal of the assets at the company tier, this disposal from one company to the other will not trigger a tax charge. The clauses extend those provisions to SEs created by the ECS and we see no particular need for any compliance provision over and above that provided for any other merger involving a UK company.

## Consultation

**5.33** Within government we have consulted the DTI and reviewed the responses received to their October 2003 consultation. We also published a technical note along with draft clauses and a partial RIA on 19 January 2005 asking for comment from the business community.

## Monitoring and Evaluation

**5.34** In the first year from its introduction, our remit of monitoring and evaluating SE take up and use will be to ensure this legislation adequately provides for SEs in UK law and if it does not, then to engage with users and potential users of SEs to see what further changes may be needed. We will also set in train work to monitor the extent to which SEs are being made use of in other EU countries and if take up is markedly different from the UK experience to look at the reasons why this is the case.

## Summary and Recommendation

**5.35** We believe the ECS represents an important step in the development of a single internal market. It will enable UK business to operate on the same basis as their EU competitors and for EU businesses to structure themselves more effectively to compete on a global stage.

**5.36** The draft tax clauses published in the Technical Note of January 19 2005 provide the required certainty for UK companies to consider the merits of SEs as a corporate wrapper for their business.

## Contact Point

William Fry  
Business Tax  
3/35  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2642

E-mail: [William.Fry@ir.gsi.gov.uk](mailto:William.Fry@ir.gsi.gov.uk)

**REGULATORY IMPACT ASSESSMENT****Direct Tax Changes Resulting from the Implementation  
of the EU Regulation on the European Company****Statement of Ministerial Approval**

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

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 2 March 2005

# 6

## RIA FOR CHANGES TO THE QUARTERLY INSTALMENT PAYMENTS REGIME FOR OIL COMPANIES

### Purpose and Intended Effect of the Measure

#### *The Policy Objectives*

**6.1** The Government is committed to delivering a tax regime for the North Sea, which promotes investment and takes a fair share of revenue derived from a national resource.

**6.2** The objective of this reform is to ensure that the Exchequer receives an appropriate share of the benefits accruing to oil companies from the sale of North Sea oil. The reform will achieve greater alignment of the payment profile for ring fence corporation tax (RFCT) and supplementary charge (SC) with the payments of petroleum revenue tax (PRT).

#### *Background and Introduction*

**6.3** Corporation tax (CT) is due and payable nine months and one day after the end of a company's accounting period. Finance Act 1998 introduced a system of quarterly instalment payments (QIPs) for large companies (currently those with annual profits exceeding £1.5 million and liability in excess of £10,000).

**6.4** The system for payment of Petroleum Revenue Tax (PRT) differs from Corporation tax. There are monthly rather than quarterly instalments, tax starts to be paid earlier in the year, the bulk of the tax is paid during the period in which the revenues are earned and the whole of the estimated liability is paid by the end of the second month after the end of the period. On average PRT is paid around 2½ months after the middle of the accounting period.

**6.5** This measure amends the system of payments for companies paying ring fence CT (RFCT) and supplementary charge (SC) i.e. companies carrying on oil extraction activities or activities connected with oil rights in the UK. In future such companies will need to estimate separately the RFCT and SC due and pay that amount by way of three instalment payments rather than four. Any CT due on other profits will continue to be paid by quarterly instalments.

#### *The Risks Being Addressed*

**6.6** The current structure of the North Sea fiscal regime is such that RFCT, SC and PRT act effectively as cash flow taxes: all income is recognised as it is earned, virtually all expenditure is relieved as it is incurred, and the difference between income and expenditure is subject to North Sea taxes (as appropriate).

**6.7** With the abolition of PRT for post 1993 fields there has been a gradual reduction in the proportion of total North Sea revenues arising from PRT, with an increasing percentage reflecting RFCT (and SC) receipts. Because the average payment date for PRT falls before those for RFCT and CT this shift has meant that the timing of payment of North Sea tax liabilities is, on average, falling due later, with a correlating delay in the receipt of the Government's share of the benefits of North Sea oil.

## Options

### *Do Nothing*

**6.8** This option does nothing to meet the Government's policy objectives of aligning the payment profile of ring-fence corporation tax more closely with the payment of petroleum revenue tax and ensuring that the Exchequer receives an appropriate share of the benefits accruing from the sale of North Sea Oil.

### *Option 2*

**6.9** Move to a system of RFCT and SC payable in three instalment payments rather than four.

### *Option 2a*

**6.10** Move to a system of RFCT and SC tax payable at the three instalment dates of 25 per cent / 25 per cent / 50 per cent of total RFCT and SC liabilities.

**6.11** This would minimise the financial impact of the change for oil companies. However, it does not smooth the amount of payments for oil companies or the Exchequer. The impact of back loading the tax due in this way would be to reduce the average delay in the receipt of RFCT and SC liabilities by less than a month. The average payment date would advance from five months after the middle of the accounting period currently (where the company has a 12 month accounting period) to 4¼ months.

### *Option 2b*

**6.12** Move immediately to a system of RFCT and SC tax payable in three equal instalments (33.33 per cent)

**6.13** This would meet the policy objective but give companies little time to prepare for a change introduced at Budget 2005 for the tax year 2005/06. A move to three equal instalments for 2005/06 following a Budget day announcement, would give companies only four months to prepare for calculating and paying an additional 8 per cent of their total RFCT and SC tax on 14 July 2005.

**6.14** The impact of this option would be to advance the average payment date of RFCT and SC liabilities to 3½ months after the middle of the accounting period.

### *Option 2c*

**6.15** A transitional year, 2005/06, of RFCT and SC tax payable at the three instalment dates of 25 per cent / 25 per cent / 50 per cent of total RFCT and SC liabilities, to be followed in subsequent years by a move to three equal payments

**6.16** This would address concerns oil companies might have about moving to new payment arrangements and adopting any necessary systems' changes at short notice. It would also meet the Government's policy objective of aligning the payment profile of ring fence corporation tax more closely with the payment of petroleum revenue tax and ensuring the UK Exchequer takes a more appropriate share of the benefits accruing from the sale of North Sea oil, while ensuring that, following the transitional year, payments would be smoothed for companies and the Exchequer.

## Recommendation

**6.17** Option 2c, which delivers the Government's policy objective and gives companies additional time to provide for the changes, is the recommended option.

## Risks

**6.18** No risks associated with this measure are foreseen. As described above, the aim of this measure is to align the payment profile of ring fence corporation tax more closely with the payment of petroleum revenue tax and ensure that the Exchequer receives a more appropriate share of the benefits accruing to oil companies from the sale of North Sea oil to the UK Exchequer.

**6.19** Because of the particular nature of the UK oil industry, exploiting the country's natural resources, a special regime is already in place to charge the profits of oil exploration and production to tax.

**6.20** Legal advice is that Human Rights considerations do not arise with this measure. The change to the profile of payments in respect of North Sea ring fence profits is justified by the policy objective underpinning the change.

## Benefits

**6.21** Option 1 (the baseline option) would have no economic, social or environmental benefits.

**6.22** Options 2a – 2c all result in receipts in 2005/06 of an additional £1 billion of RFCT and SC tax on profits earned in 2005, which would otherwise have been received in 2006/07. The precise figure will depend on a number of factors such as worldwide oil prices (the measure has been costed on the assumption of \$40.6 per barrel for 2005), production levels, and the dollar - sterling exchange rate. In future years, the effect on receipts will be broadly offset by the additional payments received in the previous year. The ongoing value to the Exchequer of the re-timing of tax receipts will be around £20 million per annum in discounted terms.

## Costs

**6.23** Around 100 companies will be affected by the change.

**6.24** Option 1 (the baseline option) would be expected to lead to future costs to the Exchequer because of the gradual reduction in the proportion of total North Sea revenues arising from PRT, with an increasing percentage reflecting RFCT and SC receipts. This shift has meant that the timing of payment of North Sea tax liabilities is, on average, falling due later, with a correlating reduction in the Exchequer share of the benefits of North Sea oil.

**6.25** Option 2a – 2c would be tax neutral for companies insofar as the calculation of total RFCT and SC tax will remain unchanged as will the tax liability, but would have costs for North Sea oil companies because of the change in the profile of the payment of their tax liabilities.

**6.26** The total cost of option 2a is estimated to be £12.5 million per annum gross finance costs (either additional interest or interest foregone) for all North Sea oil companies. After tax relief for interest payable the post-tax cost would be around £9

million. This is calculated at £1 billion at 5 per cent (approximate current risk free borrowing rate) interest for three months.

**6.27** Under both options 2b and 2c the additional finance costs to North Sea oil companies would be £25 million per annum gross (or £17.5 million post-tax) because the tax charge is evenly spread across the instalment payments (under option 2c the pre and post tax costs will be £12.5 million and £9 million respectively in 2005/06).

**6.28** Any additional cost of compliance for companies under options 2a – 2c will be negligible although some minor administrative changes will be necessary. The current instalment regime is based on a current year basis so all companies affected by this measure already have to make payments on these due dates and estimate liability for the year ahead. The only change necessary is an adjustment in the amount of payment due.

### Public Sector

**6.29** Changes are required to Inland Revenue IT systems and the corporation tax self assessment (CTSA) return. The cost of these changes is estimated at around £800,000 in system changes. Most other changes to forms etc will be undertaken as part of the normal Budget change process so no additional charges will accrue.

### Securing Compliance

**6.30** The normal interest and penalty provisions within the framework of the current regulations will apply to late payments. The Revenue expects that in estimating their payments, companies will follow normal commercial practice and apply corporate governance and appropriate standards. Guidance on the Revenue's approach to compliance is published on the Departmental Internet site.

### Competition Assessment

**6.31** The competition filter test has been applied to this measure. The measure has no significant impact on competition. The price of crude oil is largely determined by the global market. The additional costs to companies are very small as a proportion of their current costs and tax liabilities.

### Small Business Impacts

**6.32** The QIPs regime only applies to large companies (broadly companies with annual profits currently exceeding £1.5 million and liability in excess of £10,000). Companies will only be affected by this measure if they are already in the QIPs regime therefore there should be no impact on small businesses.

### Consultation

**6.33** As a Budget measure consultation is not considered appropriate on this measure, regulations will be published shortly after Budget day.

### Monitoring and Evaluation

**6.34** The corporation tax payments of oil companies are kept under constant review due to their impact on the overall tax take of the UK. Inland Revenue analysts will

monitor these changes in line with their normal quarterly reviews to determine the effectiveness of this policy.

## Summary and Recommendation

**6.35** Option 1 (do nothing option) would result in costs to the Exchequer because of the on-going shift in the source of Government revenues from the North Sea, from PRT to RFCT and SC, with the consequence that tax payments are, on average, falling due later and the Exchequer's share of the benefits of North Sea oil are reduced. This option would do nothing to help meet the Government's policy objective of aligning the payment profile of ring-fence corporation tax with payment of petroleum revenue tax and ensuring the Exchequer receives a fair share of revenue derived from a national resource.

**6.36** Option 2c would result in a benefit to the Exchequer, increasing RFCT and SC payments in 2005/06 and reducing the delay in RFCT and SC receipts by an average of one and a half months on an ongoing basis. The Government proposes to pursue option 2c because it promotes the policy objectives outlined above, will smooth the payment process for companies and the receipts profile for the Exchequer, while addressing possible concerns of companies about arranging increased instalment payments at short notice in year one.

## Contact Point

Jo Wakeman  
North Sea Branch  
Corporate Tax Team  
2/E1  
1 Horseguards Road  
London  
SW1A 2HQ

Tel: 020 7270 6108

E-mail: [Jo.Wakeman@hm-treasury.gsi.gov.uk](mailto:Jo.Wakeman@hm-treasury.gsi.gov.uk)

## **REGULATORY IMPACT ASSESSMENT**

### **Changes to the Quarterly Instalment Payments (QIPs) Regime for Oil Companies within the Charge to Ring Fence Corporation Tax and Supplementary Charge**

#### **Statement of Ministerial Approval**

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

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 14 March 2005

# 7

## REGULATORY IMPACT ASSESSMENT FOR BUSINESS PREMISES RENOVATION ALLOWANCE SCHEME

---

### Introduction and Summary

**7.1** This Regulatory Impact Assessment estimates the costs and benefits of the proposed scheme for Business Premises Renovation Allowance (BPRA). It reflects the responses to the public consultation document containing draft legislation published in December 2004.

**7.2** There were fourteen respondents to the consultation including individuals, representatives of the property industry, businesses, law and accountancy firms. Respondents broadly welcomed the proposal for BPRA. There has also been coverage in the press and journals and comments on the BPRA scheme have included views that it will be “immensely valuable to disadvantaged areas” and that “it is difficult not to get enthusiastic about measures of this kind”.

**7.3** Several respondents have asked for clarification of how points of detail will operate in practice. For example, there have been requests for guidance on the meaning of an “unused” building. The Inland Revenue thank respondents for highlighting particular issues where they consider that detailed guidance would assist claimants. The Inland Revenue will be publishing comprehensive, detailed guidance, for use by businesses, practitioners and Inland Revenue staff, in good time before the scheme comes in to operation.

### Purpose and Intended Effect of the Measure

#### *The Policy Objectives*

**7.4** To increase private investment, enterprise and employment in the UK’s most disadvantaged communities (designated as “Enterprise Areas”), by bringing longer-term vacant business properties, in those areas, back into productive use. The measure is part of the UK’s holistic approach to regeneration. Regeneration has wider social and environmental objectives as well as economic goals. The BPRA scheme aims to contribute to those objectives and goals through the mechanism of new and enhanced capital allowances, designed to encourage and support investment in business property renovation.

#### *Background*

**7.5** A key feature of the Government’s policy for enterprise is the recognition that social factors, the business environment and specific market failures can present barriers to enterprise within disadvantaged areas. In the 2002 Pre-Budget Report, the Chancellor of the Exchequer, Gordon Brown, announced details of approximately 2,000 Enterprise Areas on which measures would be targeted to address the barriers affecting the most disadvantaged communities in the United Kingdom.

**7.6** The Government has already introduced complementary measures that can contribute towards encouraging investment in property in deprived areas, including stamp duty relief, the Property Support Scheme and the Land Remediation Scheme.

**7.7** Generally speaking, spending on repairs to business premises can qualify for tax relief as a revenue deduction in the business’s profit and loss account.

**7.8** Capital expenditure (on substantial alterations or improvements to premises, or by a new owner, to bring premises into business use) can already qualify for some capital allowances under the existing rules<sup>1</sup>. The relevant capital allowances are:

- at 25 per cent a year (on the “reducing balance basis”) for expenditure on plant and machinery (P&M) that is, or becomes, an integral fixture of the building. If the business is a small or medium-sized enterprise (SME), then it will also be entitled to a 40 per cent initial or first-year allowance in respect of such P&M expenditure.
- at 4 per cent a year (on the “straight-line” basis) for expenditure on the fabric of industrial buildings (including certain qualifying hotels) and agricultural buildings.

**7.9** However, expenditure on the fabric of commercial buildings (such as offices and shops) does not generally qualify for any capital allowances.

**7.10** So the proposed new scheme, which would provide 100 per cent first-year capital allowances for the capital costs of renovating or converting premises that have been unused for a year or more in Enterprise Areas, would potentially comprise partly an enhanced rate of allowances and partly a new relief.

### ***The Risks Being Addressed***

**7.11** Boarded-up rows of derelict shops and empty business properties are a common sight in the most deprived areas of the UK. The Government has identified that further barriers to regeneration in these areas are caused by the presence of such properties. Available data<sup>2</sup> show: (i) that there is a significantly greater proportion of long-term empty properties in the 2,000 Enterprise Areas than in other areas of the UK and (ii) that market prices can drop so low that the costs of maintaining/refurbishing the premises would be higher than the expected yield the owner could expect to obtain as a result of incurring such costs. This is the so-called “negative rent” effect, which acts as a barrier to regeneration.

**7.12** There are also wider social benefits to regeneration that are not always captured in the returns to the private investor. So empty properties in deprived areas can be left empty and run-down even when the economically efficient solution would be redevelopment. This adds to “visual blight” and increased crime and vandalism.

**7.13** The presence of such properties can also act as a drag on the whole neighbourhood. This is sometimes referred to as the “broken window” effect, which can deter new people and businesses from locating in these disadvantaged areas<sup>3</sup>.

**7.14** Over time, the degree of dereliction can increase, until such time as the costs of renovation could outweigh any private returns. At this point the site will not be brought back into use without some form of public support. However, earlier intervention could have saved significant public funds and so would have led to economic efficiency gains. The BPR scheme will encourage early remediation, thus preventing the costs of remedying dereliction from spiralling until they become unaffordable.

<sup>1</sup> The capital allowances legislation is contained in the Capital Allowances Act 2001, as amended.

<sup>2</sup> Supplied to the Inland Revenue in the first half of 2004 by Investment Property Databank (IPD) Ltd.

<sup>3</sup> The fact that the quality and availability of properties can influence business investment decisions is a finding confirmed by a 2003 study from the University of Ulster: “Factors Affecting the Levels and Form of Private Investment in Regeneration”, a report sponsored by ODPM.

**7.15** There is also evidence<sup>4</sup> of an “enterprise gap” in the UK’s most disadvantaged communities, where business start-up rates can be around ten times lower than in more prosperous areas. The proposed BPRA scheme is designed to alleviate these problems, by encouraging and supporting private investment in enterprise in these areas.

**7.16** Finally, buildings in disadvantaged areas can often be in need of significant redevelopment and refurbishment to bring them back up to standard suitable for occupation. While the prices for purchase or lease may reflect this, the need for significant up-front investment can act as a disincentive compared to the more straightforward occupation of a building in other areas. This can increase the risk of greenfield, rather than brownfield development, with a corresponding reduction in amenity and biodiversity.

## Options

### *Do Nothing*

**7.17** Investment decisions are about weighing-up risks and rewards. Many businesses may feel unable to bear the uncertainties associated with investing in renovating empty properties in Enterprise Areas, because they may not consider that there is a reasonable balance between the perceived risks and rewards. Doing nothing will not help to redress any imbalance. It will result in the status quo continuing and will not help to regenerate disadvantaged areas.

### *A Targeted Tax Measure*

**7.18** Introduce a targeted measure, such as BPRA, to help redress the balance and to encourage increased investment and enterprise in disadvantaged areas. The advantages include the fact that the BPRA scheme should help to: (a) foster physical and social regeneration of pockets of deprivation by tackling apparent market failures; (b) increase private investment, enterprise and employment in these areas and (c) encourage brownfield development, thus reducing pressure on greenfield sites.

**7.19** The disadvantages include the fact that tax measures can be blunt instruments (they cannot, for example, help businesses that make insufficient profits to be liable for tax) and the fact that BPRA, on its own<sup>5</sup>, is a relatively modest measure, so its direct impact on regeneration could also be modest.

### *A Measure Applying Throughout the UK*

**7.20** Introduce a measure that would apply throughout the UK, which would not be restricted to the 2,000 most disadvantaged areas. The main advantage of a country-wide scheme would be the fact that it would encourage brownfield development and regeneration more generally.

**7.21** The disadvantages would include a very much higher Exchequer cost and the fact that a general scheme would not target private investment on those areas of the country that appear to need it most.

---

<sup>4</sup> A fairly recent study, in 2000, by the Bank of England concluded that “the negative relationship between deprivation and entrepreneurial activity appears to be clear cut in the case of the 50 most deprived local authorities” and found, more generally, that high levels of local deprivation appear to be associated with low business formation rates.

<sup>5</sup> Because deprivation is a multi-faceted problem, the UK Government adopts a holistic approach to regeneration. Thus BPRA would be only one of a series of measures that the Government has put in place, or plans to introduce, to tackle deprivation.

### ***A Grant-based Scheme***

**7.22** Introduce a grant-based scheme for the costs of renovating or converting empty business property. The main advantages of such a scheme would be:

- that it could be more generous, potentially offering more help with renovation costs; and
- that it could be more selective - projects could be chosen on individual merit, subjectively judged on a case by case basis.

**7.23** The disadvantages of a grant-based, as opposed to a tax-based, scheme are considered to be that:

- a tax relief-based scheme can be more effective at getting the prices right. Because the benefits of a scheme like BPRA would be widely available and fairly modest, the high ratio of private to public investment should help to discriminate between economically efficient and inefficient proposals;
- the tax system can be used to relieve particular costs in a non-discretionary and non-selective way and so can be less harmful to competition than a grant-based system;
- because tax incentives are transparent and automatic they can provide greater certainty for the investor. They can also be less bureaucratic from a public and private perspective; and
- finally tax reliefs in general, and a capital allowances scheme in particular, build upon businesses familiarity with the current system.

**7.24** Although some respondents to the consultation considered that BPRA should be a general measure that would apply throughout the UK, most appreciated the reasons why the Government is targeting BPRA on Enterprise Areas where it can do the most good. Some respondents also expressed a preference for a grant-based system, but in general, respondents accepted that a tax-based system, like BPRA, can be more transparent and less bureaucratic than a grant system, potentially ensuring wider effects for a relatively low Exchequer cost.

**7.25** The Government believes that option two, the targeted relief that BPRA would provide, is the best of the four options identified above as potential responses to the problems found in the most disadvantaged areas of the UK.

### **Business Sectors Affected**

**7.26** The Government wants BPRA to have the maximum possible impact by attracting the maximum investment into the regeneration of Enterprise Areas. So the proposed BPRA scheme would be available to all property owners and lessees who incur qualifying expenditure and who have a liability to United Kingdom tax, operating in any sector of the economy. It would be available to sole traders, partnerships, stand-alone or subsidiary companies. It is proposed that it would be available to all businesses, regardless of size, including small and medium-sized enterprises (SMEs). It is also hoped that BPRA will benefit SMEs indirectly, by increasing the stock of available and affordable properties for all businesses to let. This should be of particular help to new business start-ups, the bulk of which are SMEs.

**7.27** Respondents supported the proposal that BPRA should be available to all businesses. There was broad agreement that BPRA would benefit SMEs both directly and indirectly, albeit that some respondents felt that the main direct beneficiaries of the allowances would tend to be large businesses and property investors.

## Issues of Equity and Fairness

**7.28** One of the reasons why development is not occurring is due to problems in local property markets. Wards are a close fit to those markets. By designating disadvantaged areas at the level of electoral wards (postcodes in Scotland) the Government is able to target more accurately these smaller pockets of deprivation<sup>6</sup>. Also, targeting regeneration support on disadvantaged areas enables the Government to tackle perceived differences in economic performance at the sub-regional level. Thus restricting BPRA to spending in Enterprise Areas is designed to target the relief where it can do the most good.

## Benefits

**7.29** BPRA will benefit businesses renovating empty properties in disadvantaged areas by providing them with certainty that their qualifying expenditure will be eligible for up-front tax relief. That up-front tax relief will provide businesses with a cash-flow benefit and a shorter payback period on their investment.

**7.30** Bringing premises back into commercial use can stimulate the local economy, helping to provide jobs for local people and creating a better environment for the local community.

**7.31** It is difficult to quantify the annual number of unused building renovations in Enterprise Areas that are likely to qualify for BPRA over the five-year period of the relief's life, and also the possible wider effects in terms of job creation and environmental benefits. The Government will, however, take steps to ensure that take-up is monitored and the scheme evaluated.

**7.32** The regeneration of brownfield sites can also reduce pressure on Greenfield sites. An estimate<sup>7</sup> of the external benefits associated with Greenfield preservation puts this in the region of £180,000 per hectare.

**7.33** Finally, there are potential spill-over benefits to the area in general and to neighbouring properties, as well as wider social benefits by way of reductions in visual blight and possible reductions in graffiti and vandalism.

**7.34** However, although the benefits could be wide and difficult to quantify, it is also relevant to bear in mind that BPRA's effects would be likely to be modest and worthwhile mainly as part only of the Government's holistic approach to the multi-faceted issues involved in regeneration.

**7.35** Respondents commented that the wider effects of BPRA to boost improvements to property and provide desirable workplaces would benefit all stakeholders.

<sup>6</sup> The expression "pockets of deprivation" refers to the incidence of deprived communities, often close to prosperous areas, which is a particularly marked feature of the UK economy. Historically, this situation seems to have arisen because some UK communities are still struggling to cope with the transition from a traditional economy to a new one, and suffer from a lack of skills, innovation and enterprise. Other of these communities have faced decades of disinvestments in housing and job creation. In any event, there is evidence of a significant "enterprise gap" between the UK's most disadvantaged and most prosperous communities (see paragraph 13) and of the fact that there are significant sub-regional differences in GDP per capita, unemployment rates and in levels of economic activity.

<sup>7</sup> By the Office of the Deputy Prime Minister (ODPM).

## Costs

### *Implementation (Compliance) Costs*

**7.36** These are considered to be small or negligible. Capital allowances are a long-standing and well-understood feature of the tax system. The introduction of BPRA will not introduce any special additional compliance costs for businesses.

**7.37** Views on the appreciability of compliance costs amongst respondents to the consultation were mixed. Many respondents did not raise them as an issue, while others said they either would be an issue or broadly agreed they should be negligible. On balance, while BPRA may in some cases require a small amount of professional advice to determine the value of qualifying expenditure, the marginal cost of this should be small and needs to be seen within the context of the overall tax computation.

**7.38** Businesses will need to compute their claims as they do currently for other capital allowances. Claims will be made on income tax or corporation tax returns in the usual way and it is envisaged that the returns will include a new box for individuals or companies to complete if they wish to claim BPRA.

**7.39** BPRA is a targeted scheme and detailed rules are needed to focus the relief and these also provide certainty for business. The Inland Revenue's detailed guidance on the scheme will provide clarity and certainty to businesses and practitioners and so should also contribute to minimising any additional compliance costs.

### *Exchequer Effect / Distributional Impacts*

**7.40** At Budget 2004 the Chancellor announced that subject to state aids approval BPRA will be introduced in 2005. The Exchequer cost of BPRA is estimated at £10 million in 2005/06, £35 million in 2006/07 and £30 million a year for each of the next three years from 2007/08 to 2009/10.

### *Small Business Impacts*

**7.41** There should be no additional costs for small businesses.

**7.42** Small businesses that incur qualifying expenditure will be able to claim the new allowances by completing a box on their income or corporation tax return (as the case may be).

**7.43** It is likely that the majority of premises renovated under the scheme will be tenanted by smaller businesses<sup>8</sup>. This should be an indirect benefit to SMEs to the extent that the stock of available and/or affordable business premises may be increased by the measure, and to the extent that landlords may feel more able to reduce rents because of the support provided by BPRA tax relief. Respondents agreed that smaller businesses would benefit directly through the accelerated tax relief available on their spending on renovating business and indirectly through the increase in the stock of available business premises.

---

<sup>8</sup> Data supplied by IPD Ltd to the Inland Revenue in the first half of 2004 suggests that of new leases taken out on premises vacant for more than one year, 31 per cent are by large businesses and the remaining 69 per cent by SMEs. This finding is more pronounced in deprived areas where the split is 26 per cent and 74 per cent for large businesses and SMEs respectively. This suggests that large businesses are less likely to take out a new lease on premises with a vacancy history, and that, in deprived areas, newly renovated buildings which have been vacant for a longer period, are almost three times more likely to be occupied by smaller than by larger firms.

### ***Other Costs and Benefits (Public and Private Sector)***

**7.44** This new measure will result in negligible administrative costs to the Government. There will be some new costs if a new BPRA claim box is added to the tax returns and in producing staff guidance for the new scheme, but it is believed that these costs are unlikely to be significant.

### ***Unintended Consequences***

**7.45** It might be suggested that some businesses would deliberately keep premises vacant in order to benefit from BPRA. On this view, BPRA could be seen as providing a perverse incentive to leave premises empty.

**7.46** We consider, however, that this is unlikely to be the case because, under current tax law, the costs that a business incurs on its business premises for repairs and renewals are chargeable in full in the trading account under normal accounting practice, and are allowable in full as deductions when computing profits for tax purposes. Existing businesses would, therefore, gain no advantage by deferring any repairs and renewals and leaving premises vacant for 12 months or more in order to claim relief under BPRA.

**7.47** Furthermore, the scope of BPRA is limited. Expenditure on refurbishing business premises will not constitute capital expenditure for tax purposes (and thus be within the scope of BPRA) unless:

- it is expenditure on substantial alterations or improvements to the premises; or
- it is incurred by a new business – either as landlord or lessee – in order to bring the premises up to the standard necessary for business use.

**7.48** Relief under BPRA is, therefore, not available for the ordinary operating expenses incurred by an existing business. Even if BPRA were available in such circumstances (which it is not) it seems inherently unlikely that an existing business would forgo for a year the income that could be generated by making use of the premises, in order to access the limited benefits available from BPRA.

**7.49** Respondents to these issues expressed a range of opinions about whether the 12-month vacancy period could introduce an incentive to leave premises vacant. Most felt that commercial factors would weigh against leaving premises empty, but some felt that owners or tenants could delay renovation work.

**7.50** There was also a range of opinion about whether the 12-month vacancy period is the most appropriate in view of the policy objective of bringing disused business premises back into productive use. One respondent considered that there should be no vacancy period requirement, but it is not clear how that suggestion would address the issue of recycling premises that have fallen out of use. Other suggestions included a shorter or longer period possibly related to special circumstances.

**7.51** The Government will keep these issues under review, but is presently minded to proceed on the basis of the 12-month minimum vacancy requirement and is disinclined to further complicate the scheme with additional special rules at this juncture.

## Other Impacts

### *Devolution*

**7.52** BPRA is designed to apply to Enterprise Areas throughout the United Kingdom. In England and Scotland the areas selected are the most deprived 15 per cent of wards/areas, in Wales and Northern Ireland they are the most deprived 42 per cent of wards to reflect higher levels of deprivation in these countries<sup>9</sup>. The Government is aware that the indices of deprivation have been updated in England and Scotland and will keep the current designation of Enterprise Areas under review.

**7.53** Respondents did not raise any issues about devolution.

### *Human Rights*

**7.54** No human rights issues have been identified and none were identified by respondents.

### *E-Policy*

**7.55** No e-policy issues have been identified and none were raised by respondents.

## Environmental Impacts

**7.56** BPRA will support the recycling of existing premises that have fallen out of use. Typically, these premises will be on existing brownfield sites. Recycling existing premises can reduce the pressure for new build on greenfield sites, with the negative effects that greenfield development often has in terms of loss of amenity and biodiversity. An estimate<sup>10</sup> of the external benefits associated with greenfield preservation puts this in the region of £180,000 per hectare.

**7.57** Increased investment in disadvantaged areas can help to revitalise local communities, improve the local environment and make them better places to live and work.

### *Rural Proofing*

**7.58** No issues identified and none raised by respondents. Rural communities and agricultural businesses can benefit from disadvantaged area measures (and so could be eligible for BPRA) just as other communities and business sectors are eligible. The 2,000 designated disadvantaged areas are based on the national indices of multiple Deprivation (IMD).

**7.59** These are considered to be the best available way of targeting deprived areas, since they are based on hard statistical measures of key features of deprivation such as income, unemployment, health and poverty. So although there is, in fact, a concentration of the targeted areas in urban locations, this is a consequence of applying the key measures of deprivation uniformly to all communities.

---

<sup>9</sup> The Enterprise Areas were selected using the Index of Multiple Deprivation 2000 (England); the Welsh index of Multiple Deprivation 2000; the Scottish Area Deprivation Index 1998; and Northern Ireland Measures of Deprivation 2001.

<sup>10</sup> Made by the Office of the Deputy Prime Minister (ODPM).

## Competition Assessment

**7.60** The competition filter shows that this policy is not expected to give rise to competition issues.

## Securing Compliance

**7.61** The policy will be monitored and kept under review. Compliance will be secured using normal Inland Revenue risk assessment methods.

## Consultation

**7.62** The Chancellor has decided to introduce BPRA in the form of a 100 per cent first-year capital allowances scheme for the renovation of unused business premises in disadvantaged areas. He has also announced the aim of introducing the scheme in 2005, subject to state aids approval.

**7.63** Consultation was sought on:

- the detail of the relevant draft legislation;
- the extent to which the scheme may be expected to assist smaller businesses;
- whether a minimum vacancy period of 12 months is the most appropriate period in terms of the policy's objectives;
- whether the scheme may create a perverse incentive to leave premises empty for a year in order to qualify for BPRA relief;
- other potential effects of BPRA, including any evidence to support the view that the scheme is likely to have wider social benefits, such as a positive impact on job creation, or wider environmental benefits; and
- the number of buildings likely to be renovated under the scheme, and any inadvertent compliance burdens the scheme could create for businesses.

**7.64** The consultation closed on 1 March 2005. The overall views of respondents on the above issues are reflected in this assessment. The Inland Revenue will publish a more detailed summary of the responses received shortly.

## Monitoring and Evaluation

The overall impact of the scheme will be monitored through feedback, the examination of a sample of tax return entries and the collection of data to assess its effects. This monitoring will continue throughout the life of the relief.

### **Contact Point**

Paul Thomas  
Capital Allowances  
3/36  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2541

E-mail: [Paul.Thomas@ir.gsi.gov.uk](mailto:Paul.Thomas@ir.gsi.gov.uk)

## **REGULATORY IMPACT ASSESSMENT**

### **Consultation on the Proposed Business Premises Renovation Allowance Scheme**

#### **Statement of Ministerial Approval**

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

Signed by the responsible Minister:

John Healey  
Economic Secretary to the Treasury

Dated: 9 March 2005

# 8

## REGULATORY IMPACT ASSESSMENT FOR TONNAGE TAX

---

### Purpose and Intended Effect of the Measure

#### *The Policy Objectives*

**8.1** This regulatory impact assessment considers the implementation of revised community guidelines on state aid to maritime transport (2004/C 13/03) to ensure that the UK tonnage tax regime for shipping remains consistent with Community guidelines on state aid to maritime transport.

**8.2** These guidelines are intended to enable Member States to operate schemes (including tonnage tax regimes) to sustain and promote safe, efficient, secure and environmentally sensitive maritime transport, while ensuring that such schemes do not undermine the Single European Market.

#### *Background*

**8.3** UK tonnage tax regime introduced in 2000 was implemented as part of a package of measures to reverse the decline in the UK merchant fleet and to allow the UK shipping industry to achieve its full economic potential. It created a positive fiscal environment for UK shipping, competitive with that provided by a number of newer centres for ship operations outside Europe. This was achieved by giving companies the option to elect to have their taxable profits from shipping activities determined at fixed rates by reference to the tonnage of their ships, rather than on the basis of variable business results.

**8.4** The UK tonnage tax was designed to comply with the Community guidelines on state aid to maritime transport current at the time (97/C 205/05). The Regulatory Impact Assessment for the tonnage tax regime as a whole is available on the Inland Revenue web site.<sup>1</sup>

**8.5** In January 2004 the European Commission published revised guidelines in Commission communication C(2004)43 – Community guidelines on state aid to maritime transport (2004/C 13/03). This sets a deadline of 30 June 2005 for Member States to amend their existing schemes to comply with the revised guidelines.<sup>2</sup>

#### *The Risks Being Addressed*

**8.6** UK tonnage tax rules need to be updated to reflect the revised state aid guidelines, to ensure that the UK tonnage tax regime continues to be effective in sustaining and promoting the UK shipping industry.

**8.7** If the rules were left unchanged, then certain aspects of the UK tonnage tax would no longer comply with the state aids guidelines. Tonnage tax benefits made available to companies in such circumstances would be recoverable subsequently under state aid rules, counteracting the purpose of the regime and creating uncertainty for the shipping industry.

---

<sup>1</sup> *Regulatory Impact Assessment for Tonnage Tax*. Inland Revenue, March 2000. Available at: [http://www.inlandrevenue.gov.uk/ria/ria\\_tonnage.pdf](http://www.inlandrevenue.gov.uk/ria/ria_tonnage.pdf) website.

<sup>2</sup> The revised guidelines are available on the European Union web site at: [http://europa.eu.int/eur-lex/pr/en/oj/dat/2004/c\\_013/c\\_01320040117en00030012.pdf](http://europa.eu.int/eur-lex/pr/en/oj/dat/2004/c_013/c_01320040117en00030012.pdf)

## Options

### *Baseline Option - Do Nothing*

**8.8** Doing nothing is not a viable policy choice, as it would place the UK in breach of European Commission state aids guidelines, which are backed up by European law. However, “do nothing” has been included in the analysis of the benefits and costs to provide a baseline for assessing the options for change.

**8.9** Two broad options for change have been considered:

### *Option One - Minimum Changes to Comply with Revised State Aid Guidelines*

**8.10** This would involve making three changes to UK tonnage tax rules, with effect from 1 July 2005, to:

- exclude port towage activities from the scope of the UK tonnage tax regime. (A company currently operating a tug within the regime would be required to apply ordinary tax rules to calculate profits arising from their operation in the future, unless the tug spends more than 50 per cent of its operational time engaged in towage at sea;
- in specified financial years where the Community flagged share of global tonnage eligible for tax relief in the UK has decreased, make it a condition of bringing new non-Community flagged ships into the UK tonnage tax regime that companies at least maintain the proportion of the total tonnage of their shipping fleet operating under a Community flag at the same level, where this proportion is below 60 per cent; and
- enable Regulations to be made requiring companies operating non-Community flagged shipping within UK tonnage tax to provide evidence of compliance with Community and international standards relating to health, safety and the environment, or working conditions. A continuing failure to comply with the requirements of any such Regulations could result in revocation of a company’s election into tonnage tax, requiring the company to apply ordinary tax rules to calculate profits arising from their shipping activities.

### *Option Two - As Option One, Plus Some Optional Changes*

**8.11** This would involve making the three changes under option one, plus additional changes to the UK tonnage tax, with effect from 1 July 2005 to:

- extend the scope of the UK tonnage tax regime to include the transport activities of certain dredgers that are currently excluded from the regime. Companies would be able to bring within UK tonnage tax dredgers that spend more than 50 per cent of their operational time on transport activities at sea;
- revise the scope of the UK tonnage tax regime to include certain activities of vessels engaged in offshore activities, such as in the North Sea oil and gas industry, rather than as previously only including certain categories of

vessels. The activities will include offshore supply, towage, anchor handling, carriage of gas and liquids and safety services, as well as any combination of these activities; and

- establish arrangements to manage the exit of companies leaving the regime. In particular, these arrangements would enable shipping businesses to give notice, by 31 March 2006, that they want to withdraw from the UK tonnage tax regime in advance of the end of their original election into the regime. This provides any company adversely affected by the changes with the option of reverting to applying ordinary tax rules. The rules applying to an exit under these circumstances, or at the expiry of a tonnage tax election would be amended to remove some existing tax disincentives to voluntary withdrawal from tonnage tax.

**8.12** The full detail of the changes proposed by option two (and some further, minor technical clarifications that would also be made) are set out in the Finance Bill.

### **Business Sectors Affected**

**8.13** The options have direct implications for the UK shipping industry and indirect implications for customers of the shipping industry.

**8.14** 76 shipping businesses have joined the UK tonnage tax regime and these businesses operate over 750 ships in the regime. Other shipping businesses may be currently operating outside tonnage tax but might have new opportunities to participate in the regime in the future, if they are undertaking activities such as the transport of aggregates or the operation of North Sea specialist vessels.

### **Equity and Fairness**

**8.15** A key purpose of Community state aids guidelines is to support the Single European market and prevent unfair competition. Changing UK tonnage tax rules to ensure that they continue to comply with state aid guidelines will contribute to ensuring fair competition.

**8.16** However, there is also an issue of fairness in respect of businesses adversely affected by the changes. If implemented, the element of option two enabling companies to withdraw from the UK tonnage tax regime would make the changes fairer for port towage operators who made ten year elections into UK tonnage tax in the expectation that the regime would continue as now. They would no longer be subject to certain measures designed to discourage voluntary exits from tonnage tax.

### **Benefits**

**8.17** The baseline 'option' (do nothing) would have no economic, social or environmental benefits.

### **Economic**

#### ***Option One - Minimum Changes***

**8.18** This option would generate a tax yield for the Exchequer of up to £5 million per year after three years. It could have some marginal benefit to port towage operators outside UK tonnage tax, by providing a fairer basis for competition.

### ***Option Two - Minimum Plus Optional Changes***

**8.19** This option would have benefits to industry arising from a reduction in tax, (matching the cost to the Exchequer) of up to £5 million per year. This would benefit shipping companies undertaking activities brought into the scope of UK tonnage tax for the first time (transport by some dredgers and certain activities undertaken by vessels engaged in offshore activities, e.g. in the North Sea oil and gas industry). This would help sustain and promote the role of the UK shipping industry in competing in these activities, giving rise to wider, indirect economic benefits.

#### ***Social***

**8.20** The recent review of UK tonnage tax discusses some of the social benefits associated with the UK tonnage tax. In particular, there has been an increase in the number of cadets being trained. By extending the scope of UK Tonnage tax to include some dredgers and certain extra offshore activities, option two could deliver more social benefits in the future than the baseline option or option one.

**8.21** If, under either option, any new Regulations were to be introduced in the fields of health, safety, environment or working conditions, there might be additional social benefits.

#### ***Environmental***

**8.22** Option one (minimum changes) is unlikely to give rise to any environmental benefit. Option two could give rise to some marginal environmental benefit by helping to sustain and promote the role of the UK shipping industry in transporting aggregates and undertaking certain North Sea activities.

#### ***Costs***

##### ***Economic***

**8.23** The baseline option (doing nothing) would be expected to lead to future costs to companies. This is because although the UK tonnage tax was designed to comply with the state aid guidelines current at the time, the UK is now required to update the regime by 30 June 2005 to reflect the recent changes to state aids guidelines.

**8.24** If the regime is not updated, the European Commission could be expected to require subsequent recovery of tax benefits received after revised state aids guidelines take effect, to the extent that those tax benefits might no longer be permitted under the revised guidelines. In the long run these costs could be expected to be the same as for option one, though with the added economic impact of creating financial uncertainty for the shipping industry and giving rise to unnecessary legal and administrative costs for the industry and for Inland Revenue.

**8.25** Option one (minimum changes) would have costs to the shipping companies undertaking port towage no longer eligible for UK tonnage tax matching the yield to the Exchequer and rising to up to £5 million per year yield after three years.

**8.26** Option two (minimum and optional changes) would have a direct cost to the Exchequer of up to £5 million a year, matching the benefit to the shipping industry.

**8.27** Under both options one and two, there could be some additional costs to shipping companies in UK tonnage tax operating non-Community flagged vessels, if

any additional regulation of health, safety and environment and working conditions is required.

**8.28** There will be some administrative costs to shipping companies in UK tonnage tax, for example arising from new requirements to monitor the proportion of their fleet operating under Community flags.

### ***Social***

**8.29** By keeping all dredgers and certain North Sea vessels outside UK tonnage tax, the baseline option (do nothing) or option one (minimum changes) could lead to operators with no UK presence increasing their share of these markets and the loss of social benefits being delivered to the UK by existing UK operators.

### ***Environmental***

**8.30** By keeping all dredgers and certain North Sea vessels outside UK tonnage tax, the baseline option (do nothing) or option one (minimum changes) could lead to operators with no UK presence increasing their share of these markets, leading to increases in vessel travel distance and fuel consumption.

### **Small Business Impacts**

**8.31** From the information available to the Inland Revenue, none of the 76 businesses currently in tonnage tax have been identified as a small business (e.g. under the European Commission definition of small businesses used for state aid purposes). So, there should be little direct impact on small businesses. However, many of the businesses make multiple tax returns because they operate through a series of companies, and this will be taken into account in developing the details of the administrative and compliance arrangements.

**8.32** If any small businesses operate vessels, or want to start up operations, that would be brought within UK tonnage tax under option two (i.e. aggregate transport and certain offshore activities), then that option would benefit those small businesses.

### **Competition Assessment**

**8.33** The competition filter test has been applied and no significant adverse impacts on competition have been identified for either option.

**8.34** There is existing competition in the markets affected by the changes and the UK tonnage tax regime is open to new entrants to the market.

**8.35** By extending the scope of UK tonnage tax to some dredgers and certain additional offshore activities, option two would enhance the ability of the UK shipping industry to compete in these fields, while keeping within the Single European Market rules.

### **Securing Compliance**

**8.36** Inland Revenue already has compliance systems in place in respect of businesses' obligations to correctly assess and pay tax under corporation tax rules, including UK tonnage tax rules.

**8.37** The detailed compliance arrangements will be designed to fit in with existing systems, to keep compliance costs to the minimum for the shipping industry and for the Inland Revenue.

### Consultation

**8.38** The Inland Revenue and Department of Transport published a joint Post Implementation Review of UK tonnage tax on 22 December 2004, together with legislative proposals and a partial RIA. Comments were invited from all interested parties. Industry representative bodies and others welcomed the proposed changes. A summary of the responses is available on the Inland Revenue website.<sup>3</sup>

### Monitoring and Evaluation

**8.39** The UK tonnage tax has recently been reviewed more generally, and the optional changes in option two take account of the findings of the review, which is being published at the same time.

**8.40** Future monitoring and evaluation of changes will be achieved through monitoring and evaluation of the UK tonnage tax as a whole. It is envisaged that this work will be co-ordinated with the next review of the Community guidelines on state aids to maritime transport (due before January 2011).

### Summary and Recommendation

**8.41** Option one (minimum changes) would result in a yield to the Exchequer, but work against the Government's objective to sustain and promote the UK shipping industry. Option two would result in an Exchequer cost, but would consolidate and expand the successful role of UK tonnage tax in sustaining and promoting the UK shipping industry, within the bounds set by Community state aids guidelines.

**8.42** The Government proposes to pursue option two, and has worked closely with the shipping industry to design the detail and implement the changes in a way that will maximise the benefits and minimise the costs, disruption and administration for the industry. Administrative costs of complying with the regime and the amendments stemming from this report will be subject to a further review in June 2007.

### Contact Point

Geoff Barnard  
International  
3c18  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2734

E-mail: [Geoff.Barnard@ir.gsi.gov.uk](mailto:Geoff.Barnard@ir.gsi.gov.uk)

---

<sup>3</sup> *Post Implementation Review of Tonnage Tax*, December 2004. [http://www.inlandrevenue.gov.uk/consult\\_new/tonnagetax.pdf](http://www.inlandrevenue.gov.uk/consult_new/tonnagetax.pdf)

---

## REGULATORY IMPACT ASSESSMENT

### Tonnage Tax - Implementation of Revised Community Guidelines on State Aid to Maritime Transport (2004/C 13/03)

#### Statement of Ministerial Approval

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

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 2 March 2005



# 9

## REGULATORY IMPACT ASSESSMENT FOR VAT - PACKAGE OF PARTIAL EXEMPTION MEASURES

### Purpose and Intended Effect of Measure

#### *The Policy Objectives*

**9.1** This package of small measures will help to ensure that businesses recover a fair amount of VAT. It raises revenue by enabling Customs to combat substantial over-recovery of VAT. It clarifies some of the rules by closing loopholes and giving greater certainty to compliant businesses.

#### *Background*

**9.2** A VAT registered business (or other organisation, such as a charity) can recover from Customs and Excise, VAT on costs used in its taxable business activities. It cannot recover VAT on costs used in its exempt business activities. VAT on general costs, such as overheads, must be apportioned between taxable and exempt business activities using a “partial exemption method”. Most businesses use the “standard method”, a simple default calculation. Some, mainly larger, businesses have an individually tailored “special method”. The method is supposed to give a “fair and reasonable” recovery of VAT reflecting the extent to which the business uses its costs in its taxable activities.

**9.3** Some businesses exploit weaknesses in their “special method” or in the partial exemption rules; also, some larger businesses using the “standard method” benefit unduly from a rounding easement. Some weaknesses in the rules cause uncertainty for compliant businesses.

#### *The Risks Being Addressed*

**9.4** This package of three legislative measures and one policy change will enable Customs to address over-recovery of VAT through partial exemption methods, and will close some loopholes. All the measures are legal in EC VAT law. This package is expected to achieve its objective without significant downsides for businesses or for Customs.

### Options

**9.5** Whether or not to implement this package of measures.

### Benefits

#### *Economic*

**9.6** This package will raise £25-30 million revenue by combating over-recovery of VAT through partial exemption methods. It will allow Customs to use its specialist partial exemption resource more efficiently. It will not significantly increase compliance costs.

#### *Social*

**9.7** Minimal.

### ***Environmental***

**9.8** Minimal.

### **Costs**

### ***Economic***

**9.9** Minimal compliance cost for a few large businesses in amending their VAT accounting systems.

### ***Social***

**9.10** Minimal.

### ***Environmental***

**9.11** Minimal.

### **Equity and Fairness**

**9.12** This package of measures will help to ensure that businesses can recover a fair amount of VAT and enable Customs to challenge substantial over-recovery. It will also provide certainty and a fair VAT recovery for businesses in key areas.

### **Small Business Impacts**

**9.13** No consultation has been conducted to avoid forestalling by larger businesses. The measures will not affect small businesses as the measures are either targeted at larger businesses or they correct problems that, in Customs' experience, do not arise with small businesses.

### **Competition Assessment**

**9.14** This package marginally assists fair competition by combating over-recovery of VAT by some businesses.

### **Securing Compliance**

**9.15** These measures will fit into the existing enforcement regime for VAT. Customs' specialist partial exemption staff will lead the assurance effort to ensure these measures are applied correctly. Errors in application of the rules may result in Customs making an assessment of VAT. Alternatively Customs may use one of their powers in the partial exemption area, for example, the power to direct what "special method" a business should use.

**9.16** This legislation will not impose any new criminal sanctions for non-compliance, as it relies (where necessary) on the existing offences in the VAT Act 1994.

### **Monitoring and Review**

**9.17** These measures will be monitored as part of Customs' ongoing review of partial exemption rules, including gathering evidence of effectiveness.

## Consultation

**9.18** No consultation has been conducted to avoid forestalling.

## Summary and Recommendation

Option	Total cost per annum Economic, environmental, social	Total benefit per annum Economic, environmental, social
Implement package	Minimal	£25-30 million additional revenue Greater certainty for business and Customs
Do nothing	Nil	Nil

## Contact Point

Colin Strudwick  
Customs Policy Group  
3E/02  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 0567

E-mail: [colin.strudwick@hmce.gsi.gov.uk](mailto:colin.strudwick@hmce.gsi.gov.uk)

## REGULATORY IMPACT ASSESSMENT

### VAT: Package of Partial Exemption Measures

### Statement of Ministerial Approval

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

Signed by the responsible Minister:

Dawn Primarolo  
Paymaster General

Dated: 2 March 2005



# RIA FOR REDUCED RATE VAT ON AIR SOURCE HEAT PUMPS AND MICRO CHP UNITS

## Purpose and Intended Effect of Measure

### *The Policy Objectives*

**10.1** The measure will extend the reduced rate of VAT to the installation of air source heat pumps and micro-combined heat and power units (CHP) in homes and certain residential and charity buildings. It is intended to promote energy efficiency, encourage use of new technologies and contribute to the Government's commitment to reduce carbon dioxide emissions.

### *Background*

**10.2** As part of its climate change programme, the Government is committed to reducing emissions of the gases responsible for global warming. The Kyoto Protocol commits the UK to reduce its greenhouse gas emissions to, on average, 12.5 per cent below 1990 levels between 2008 and 2012. The Government also has a national goal to move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010.

**10.3** The Energy White Paper published in February 2003 restated the Government's commitment to its climate change goals and emphasised that energy efficiency is one of its priorities. Households are responsible for a quarter of all emissions, and need to be a significant part of strategy to achieve environmental goals.

### *The Risks Being Addressed*

**10.4** Renewable sources of energy, such as heat pumps and micro-CHP, offer a cost-effective and environmentally friendly alternative to conventional sources of energy. However, the markets for these products are relatively new and still in their formative stages, which means that the cost of this technology is higher than conventional heating systems. A reduced VAT rate would support this young technology and help it to develop. It would help to reduce the price of this equipment, whilst giving a positive signal to consumers. This measure follows the implementation of the reduced rate for installation of other energy saving materials in previous years.

### **Options**

**10.5** There are two options: do nothing, retaining the standard rate of VAT (17.5 per cent) on the installation of such equipment or apply a reduced rate of VAT (5 per cent) to the installation of such equipment.

### **Benefits**

#### *Do Nothing*

**10.6** Under this option there would be no loss of taxation revenue to the Exchequer and no compliance burdens on industry.

### ***Apply a Reduced Rate***

**10.7** VAT provides a targeted response to the main causes of market failure, by:

- reflecting the environmental costs of purchases: VAT rates are able to do this more effectively than many other policy instruments can. Reducing the rate of VAT on energy efficient and energy saving products, lowers the price differential between them and energy inefficient goods. This helps correct market failure by reflecting more closely the cost to the environment of less efficient products;
- targeting the final consumer, reducing the rate of VAT leads to a fall in the price of the products, which in turn, triggers increased demand and encourages the development of energy-efficient products; and
- sending out a clear signal to the market, which helps to reduce the impact of imperfect information on consumer's decision-making.

### ***Environmental***

#### ***Air Source Heat Pumps***

**10.8** A dedicated air source heat pump is estimated to save in excess of two tonnes of carbon emissions per year. Thus the reduction in carbon emissions may be estimated for the projected growth in the market.

			<b>Carbon savings (tonnes)</b>	
<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>
3,873	10,000	11,931	14,236	16,985

#### ***Micro-CHP***

**10.9** The estimate of carbon savings is based on an average three bedroom, semi-detached house, where it is assumed the micro-CHP unit can only provide 80 per cent of heat demand and a supplementary condensing boiler is used to provide the additional 20 per cent. The potential reduction in CO<sub>2</sub> emissions as a result of the projected number of units in operation each year, is illustrated below.

	<b>Carbon savings (tonnes; compared with condensing boilers)</b>			
<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>
700	9,900	27,700	59,600	118,200

### ***Costs***

#### ***Do Nothing***

**10.10** There would be no compliance burdens on the industry or fiscal costs to the Exchequer.

## ***Apply A Reduced Rate***

### ***Air Source Heat Pumps***

**10.11** The likely cost to the Exchequer is likely to be less than £1million in the first year and up to £2.4 million in the following three years.

### ***Micro-CHP***

**10.12** The likely cost to the Exchequer of such a measure is likely to be £1million in the first year of introduction and rising to £5 million in year two and £5 million in year three.

**10.13** The compliance burden will fall on installers of these products, which if they also install standard rated equipment, will have to deal with multiple VAT rates (though some may be doing so already, if they also install other energy efficiency equipment). However, the number of installers is small at the moment and they will welcome the introduction of a reduced rate for their services, which follows extensive lobbying by the industry for such a move. The energy industry has experience of reduced rates, which have been successfully introduced for installation of other energy savings products in recent years.

## **Competition Assessment**

**10.14** The introduction of a reduced rate for air source heat pumps and micro-CHP will make the products relatively cheaper in comparison with conventional heating systems and is likely to increase demand for the new technology at the expense of existing, less environmentally friendly technology. However, this is entirely the kind of behavioural change that the Government intends the measure to encourage.

## **Securing Compliance**

**10.15** The proposal will be introduced through a change to the VAT Act 1994. Customs and Excise will enforce the legislation through their risk and assurance programmes. For non-compliance the sanctions imposed will those as laid down in the VAT Act 1994.

## **Monitoring and Evaluation**

**10.16** Customs and Excise and the Treasury will endeavour to monitor the effect of the introduction of the reduced rate, as distinct from other causes of changes in demand for these products, and will make full use of our continuing contacts with the industry.

## **Consultation**

**10.17** There has been informal consultation with the industry and wide consultation between the Department of Environment, Food and Rural Affairs, HM Treasury and HM Customs and Excise over the proposal.

**Contact Point**

Jack Fletcher  
Customs Policy  
4W  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 0252

E-mail: [jack.fletcher@hmce.gsi.gov.uk](mailto:jack.fletcher@hmce.gsi.gov.uk)

**REGULATORY IMPACT ASSESSMENT****Reduced Rate of VAT on Air Source Heat Pumps and  
Micro Combined Heat and Power Units****Statement of Ministerial Approval**

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

Signed by the responsible Minister:

John Healey  
Economic Secretary to the Treasury

Dated: 9 March 2005

# A

## APPENDIX TO REGULATORY IMPACT ASSESSMENT FOR PENSION SIMPLIFICATION

---

### Introduction

**A.1** This is an appendix to the Regulatory Impact Assessment “*Simplifying the taxation of pensions*” published on 8 April 2004. It updates the pensions simplification measures as set out in that Assessment to take account of additional legislative changes announced at PBR 2004 and Budget 2005.

### Background

**A.2** The taxation of pensions will be radically simplified from 6 April 2006. There will be a single, universal regime for tax privileged pensions to replace the existing complex regimes. This will improve choice and flexibility for pension providers, employers and individual pension savers, provide greater encouragement for individuals to save for retirement and reduce administration and compliance costs for the pensions industry. The relevant legislation is contained in Finance Act 2004 and regulations to be made under that Act.

**A.3** A further package of pensions simplification measures, building on those in Finance Act 2004, is now being introduced. Many have been developed as a result of ongoing liaison with the pensions industry following Finance Act 2004.

### Summary of Measures

**A.4** The full package of additional measures is set out in the Inland Revenue Technical note published on 16 February 2005.<sup>1</sup>

**A.5** The package includes measures requested by the pensions industry since Finance Act 2004, to allow additional flexibility in scheme design. There are some new transitional rules, which protect existing rights, and smooth the transition to the new regime for individuals, employers and schemes. Some examples are set out below. There are also some minor rules that clarify the Finance Act 2004 legislation, and some anti-abuse measures, to counter potential exploitation of the new regime’s very generous tax privileges.

### *Measures to Increase Flexibility*

**A.6** These include:

- a rule to allow the maximum tax free lump sum that may be taken to be calculated at a scheme level, rather than, as now, at an arrangement level. This will allow individuals more flexibility to amalgamate AVCs and other pension benefits within the same scheme, so as to maximise their tax free lump sum within the authorised limits;
- a rule to deal with annuities that provide for an income to be paid to the member’s dependant following the death of the member. The cost of the dependant’s annuity will be included from both the amount tested against

---

<sup>1</sup> Technical note: *Pensions Simplification*, February 2005, available at: <http://www.inlandrevenue.gov.uk/pensionschemes/pensions-simplification-tn.pdf>

the lifetime allowance and the calculation of the maximum tax free lump sum;

- The requirement for schemes with fewer than 50 members to provide scheme pensions through an insurance company will be removed. This should give schemes and employers more flexibility in the provision of pensions. The definition of lifetime annuity will be extended to allow more flexible annuity products; and
- The definition of dependant will be extended so that schemes may provide a dependant's pension to an individual married to the member when the member began to receive a pension, but divorced from the member before the member's death.

### ***Measures to Smooth Transition to the New Regime***

**A.7** These include:

- transitional measures to allow schemes to continue to make payments that otherwise could be caught under unauthorised payment rules – such as allowing pensions in payment to children over 23 in full time education to continue and allowing funeral expenses to be met where the right already existed and the member has retired before 6 April 2006;
- measures to deal with legacy schemes to minimise administration costs such as ensuring burdensome data input obligations are not imposed on annuity providers and bringing all pensions annuities into PAYE from 6 April 2007;
- a measure to allow relief to continue to be claimed on contributions to overseas schemes where the claimant was entitled to relief at 6 April 2006; and
- a rule to protect an individual's accrued rights at 6 April 2006 to draw a pension commencement lump sum even if there is no right to a pension under the particular scheme.

### **Implementation**

**A.8** We are continuing to work closely with those impacted to ensure they understand their obligations in advance of 6 April 2006 and that changes are implemented in a way that reduces the administrative burden to the pensions industry. For example workshops have been run to discuss online filing arising for schemes and are liaising with industry on how we can work with providers to bring all pensions annuities into PAYE. We have set up a readers' panel to help us produce guidance for the new regime.

### **Impact of Additional Measures**

**A.9** Having carefully considered the impact of the additional measures our assessment is that they do not alter the assessment of impacts and costs set out in the original Regulatory Impact Assessment. In particular the measures to assist scheme flexibility and to smooth the transition to the new regime will enable the full benefits as set out in the original assessment to be realised. The minor technical amendments introduced merely ensure that the legislation works as intended and will not affect the

costs or impacts as originally assessed. The anti-abuse measures being introduced will help prevent the new rules being used for unintended purposes.

**A.10** Overall these represent constructive additions to the simplification package and will help deliver a system that is flexible, easy to operate and tailored to the needs of its users.

### Contact Point

Barbara Conroy  
Pensions Policy  
Room G63  
1 Parliament Street  
London  
SW1A 2BQ

Tel: 020 7147 2872

E-mail: [pensionsconsult@ir.gsi.gov.uk](mailto:pensionsconsult@ir.gsi.gov.uk)

Please put the phrase “Regulatory Impact Assessment” in the subject line of your e-mail or letter.



# B

## SUMMARY OF RESPONSES TO CONSULTATION - TAX RELIEF FOR SPINOUT COMPANIES

---

### Introduction

**B.1** The Chancellor of the Exchequer announced on 2 December 2004 a new tax measure, effective from that date, to help researchers acquiring shares in spinout companies created with universities and research institutions. To support the announcement the Inland Revenue published a Technical Note and a Partial Regulatory Impact Assessment (RIA) on the same date.

**B.2** The Technical Note explained how the measure would operate in practice and the Partial RIA provided a background to the measure, setting out various options, benefits and costs associated with it. Both documents contained questions which observers were asked to consider and comment on during the period of the consultation that ended on the 10 February 2005. Many responses were received earlier in the consultation period and these were used to inform the draft legislation.

**B.3** Draft legislation and Explanatory Notes were published on the 10 February 2005. Today in addition to this consultation summary, a Final RIA on the measure has also been published and it reflects comments received on the Partial RIA.<sup>1</sup>

**B.4** We received over 45 responses primarily from universities, accountancy and legal professionals. A list of the respondents is at Appendix 1. We are very grateful to these respondents for all the comments made. Many comments were very detailed and we recognise the time and effort that went into them: the majority were on the Technical Note and only a few on the Partial RIA. The comments enabled us to make improvements from the proposals in the Technical Note in the draft legislation that was published on 10 February 2005 and which will be included in Finance Bill 2005.<sup>2</sup>

**B.5** The summary of the responses that follows is divided into two parts matching the two parts of the document that formed the basis of the consultation.

### Responses to Specific Questions in the Partial RIA

**B.6** All the respondents welcomed the measure. The Partial RIA asked questions in areas where our information was not complete or inconclusive. The additional information we were seeking would help us to better demonstrate the costs, benefits and impact of the new measure. As stated earlier the response on the Partial RIA questions was not very substantive but some useful comments are reflected in the Final RIA and summarised below.

### *Number of Spinouts that did not proceed because of the Schedule 22 issue*

**B.7** Responses to the consultation did not provide evidence of the number of spinouts that did not proceed because of Schedule 22 but they confirmed that the legislation had added a complication and a delay to some spinout creation. At least one Research Institution (RI) had recommended that spinouts should not be used, although in the event even there a spinout had gone ahead.

---

<sup>1</sup> The Final RIA is available on the Inland Revenue website: [www.inlandrevenue.gov.uk/ria](http://www.inlandrevenue.gov.uk/ria)

<sup>2</sup> To view the Partial RIA and Technical Note published on the 2 December 2004 visit the Inland Revenue website: [www.inlandrevenue.gov.uk/pbr2004/sup\\_newtax\\_spinout.pdf](http://www.inlandrevenue.gov.uk/pbr2004/sup_newtax_spinout.pdf)

### ***Figures on the number of Spinouts formed since April 2003 and an indication of the number that have used the two Spinout Company Models***

**B.8** These figures were requested to help determine how many spinout companies proceeded with the use of models that gave tax certainty and did not create an immediate income tax and NIC charge on the researchers, or any charge at all in the event of failure. Respondents provided some information, which indicates that about 90 companies were formed since April 2003. It was not possible to establish the exact number of companies included in these that have used the models, but indications suggest less than six for each model.

### ***Information about Spinout Companies set up by other RI Organisations and how IP transfer is achieved by these Organisations***

**B.9** No feedback was received on the number of spinouts created by non-university RIs and what model they adopted to transfer IP. However, we were made aware of the fact that some NHS Trusts and charities collaborate with universities to jointly develop IP through a spinout company and the draft legislation reflects this.

### ***Firmer figures on the number of Spinouts undertaken since April 2003 in the University and wider sector and how many researchers are involved in these***

**B.10** These figures were requested to help quantify the impact of Schedule 22. We were told about 90 spinouts were undertaken. There was no specific feedback from the consultation on the number of researchers but anecdotal evidence suggests between 120 and 150 were engaged in spinouts created since April 2003.

### ***Costs associated with starting up Spinout Companies to take into account Schedule 22 Rules***

**B.11** Comments received from the consultation suggest the increased legal and professional advisory costs because of the impact of Schedule 22 were between £20,000 to £50,000 per spinout. These costs are in addition to the additional time spent on ensuring the spinout company followed all the correct steps to defer a charge to income tax and national insurance contributions. However, it is not possible to assert that the introduction of the new measure will remove these costs entirely. As with any commercial or business transaction some initial professional advice will be necessary and we would expect some at least of this to be directed to ensuring the spinout company meets the criteria of the new legislation.

### ***Average time needed and estimate of costs to achieve familiarisation with the operation of the new measure***

**B.12** No figures are available to help determine the cost associated with familiarisation of and establishing a spinout that benefits from the new rules. However, we consider some savings may be achieved in terms of professional advisory costs by those involved in spinouts because simpler share structures can be used. The Revenue

will also be producing comprehensive guidance as soon as possible to assist researchers and RIs who are considering creating spinout companies.

## Responses to the Technical Note

### *Application of the deemed tax election to give full benefit of the measure where researchers acquire restricted shares*

**B.13** Most respondents agreed this was a good rule as it removes the need to consider making a joint tax election on the acquisition of the shares in the spinout company. However, several respondents envisaged circumstances where an automatic election would lead to a tax charge and therefore proposed the ability to opt out of the deemed election. The draft legislation incorporates this suggestion. It will be possible for a researcher to defer an immediate charge to income tax and NICs if one would arise on other elements of value received, such as funding already in the company. However the benefit of the measure will not be available at that later date.

### *Definition of Intellectual Property – any items that might be transferred but not included in the definition*

**B.14** We have followed the definition of IP as provided in paragraph 2(2) of Schedule 29, Finance Act 2002. This list is comprehensive and we have added goodwill associated with IP to reflect some of the respondents' concerns. We have not provided a "sweep-up" provision to catch everything that may be described as IP but have included a power to amend the definition of IP for the purposes of this section so that it can be changed to meet future commercial needs.

**B.15** Some respondents wanted any form of support, such as free premises, from a RI to qualify for the relief. We looked at this against the original issue presented to us: the unique feature of IP sharing agreements, which influences the transfer of IP to spinout companies. We are aware that many RIs do not allow spinout companies to use other resources without payment. In those circumstances it would be wrong to give a competitive advantage to those entities that do not operate at arm's length in this respect and have therefore decided against doing this.

### *Transfer of IP*

**B.16** This concept encouraged a number of comments on different aspects.

**B.17** Firstly, the actual transfer of IP may occur in a variety of ways. A majority of the respondents did not agree that the transfer of IP always occurred under a formal "IP sharing policy". The draft legislation does not stipulate the existence of such a policy as criteria for the tax relief but we envisage that the transfer of IP would not take place without some form of underpinning legal agreement for that transfer.

**B.18** Secondly, very often an intermediary company undertakes the transfer of IP on behalf of the Research Institution (RI). We were advised that these companies are sometimes wholly owned by the RI, may include a funding partner or are owned between two RIs. The proposed relief now covers cases where the transfer goes via an intermediate company that may be controlled by one or more RIs. And in response to comments we have allowed for a scenario where IP is transferred under joint

collaboration between RIs and the researchers from either or any of the RIs may be working on any element of the IP transferred from any of the collaborating RIs.

**B.19** Thirdly, there were comments about the tax implications of the subsequent transfer of IP into the spinout. This could be an instalment of or related to the original IP or new IP. We have accepted these comments and the draft legislation ignores the value of any subsequent transfer of related IP, by predicating the measure on the legal agreement governing the transfer, regardless of the date or dates of the actual transfer(s). However, we have not extended the relief to IP that is new and has no direct connection to the original IP sharing agreement as this would be going beyond the scope of the measure. The Government is committed to removing the unique tax barrier that is affecting the creation of new spinouts. The same imperative does not apply if IP unrelated to the original IP is later transferred to an established spinout. It is right that there should be the same liability to tax and NICs as in other established companies.

### ***Research Institution***

**B.20** There were a number of comments on the definition of a RI primarily to extend the definition stipulated in the Technical Note.

**B.21** As explained earlier the draft legislation covers circumstances where the IP is transferred via an intermediary, commonly a technology transfer company controlled by the RI. The definition is sufficiently wide enough to cover non-university institutions like NHS Trusts and charities that may also be involved in spinout activity as long as the RI or the person controlling it is not undertaking research activities for profit. The legislation contains the power to amend the definition so that in future change can be achieved immediately without recourse to primary legislation.

**B.22** Three commentators requested that the definition should extend to commercial organisations that develop IP through spinout companies. The draft legislation is designed to address a unique tax barrier to the formation of spinout companies. This tax barrier arises from a combination of the universities' IP sharing policy and the rules for the taxation of employment-related shares and securities. We are not aware of any equivalent IP sharing policies in operation in private sector companies, meaning there is no equivalent tax barrier. Private sector companies have a number of choices available to them to reward researchers, including bonuses, share options and promotion.

### ***Researchers***

**B.23** Almost all the commentators were concerned that the definition of researcher was not wide enough. We have taken a number of these comments into account in the draft legislation consistent with the policy aim.

**B.24** In the definition we have retained the link with research which has to be relevant to the development of the IP. The definition is not extended to employees who are not actively engaged in research and who may be providing peripheral support in the spinout activity, for example, business managers, administrators and secretaries. This measure is focused on persons who have worked on the research because we understand that these are usually the people who benefit from IP sharing agreements. It is this feature that can mean they acquire shares at undervalue when the IP is transferred. The rules also extend to IT and other support staff who have been actively engaged on the research.

**B.25** One commentator considered it could be divisive if those who had been actively engaged on the research that led to the IP could benefit from this measure but others could not. However, the Government cannot see any compelling reason why a person who has not worked on the original research should benefit. Representations received suggest that the original researchers are those considered crucial to future development of the IP and it was these who were put off participating by the employment-related securities legislation. If others acquire shares at an undervalue their treatment for tax purposes will be consistent with any other individual who is employed by a new company and receives shares as part of their remuneration package.

**B.26** The phrase “actively engaged” will carry its own ordinary meaning.

### *Type of Security*

**B.27** A few commentators suggested derivatives, interest in shares and shares options should be within the scope of the measure. The draft legislation is confined to securities as listed in section 420 of Part 7, Income Tax (Earnings and Pensions) Act 2003 (ITEPA), in other words, shares in any body corporate (wherever incorporated) or in any unincorporated body constituted under the law of a country or territory outside the UK. However this does include an interest in shares. Consultation has established that only these create an obstacle to the creation of spinouts through an up-front tax charge.

### *Other Comments*

#### *Valuation and Timing Issues*

**B.28** Some commentators wanted confirmation in the measure to allow valuations to be agreed in advance of shares being acquired by the researcher in order to enable those involved in spinout activity to determine any tax liability not covered by the measure.

**B.29** The Inland Revenue does not consider valuations of employment-related securities in advance of transactions except in the circumstances clearly set out at [www.inlandrevenue.gov.uk/shareschemes/svd.htm](http://www.inlandrevenue.gov.uk/shareschemes/svd.htm) and is unable to extend special treatment to spinout companies in this respect.

#### *Corporation Tax Deduction*

**B.30** Two commentators considered that a corporation tax deduction should be available to the employing company for the value of IP transferred even though the researcher would not incur an income tax charge, consistent with shares acquired through tax-advantaged schemes. However this would not be a return to the position as perceived before April 2003. It would also require valuation of the IP, which is agreed by commentators to be a major difficulty. The Government has not therefore allowed for a corporation tax deduction.

#### *Administration Points*

**B.31** The suggestion of a specialist unit to deal with the tax affairs of spinout companies was widely welcomed so that there would be consistency of advice and treatment. We are still in the process of determining how this can be best achieved. We propose that spinouts that benefit from the measure are notified to the Inland Revenue on Form 42. Any enquiries about the application of the legislation should be made to the Employee Shares and Securities Unit of the Inland Revenue.

**B.32** We aim to publish guidance on the new measure by the end of April 2005.

### ***Spinouts created before 2 December 2004***

**B.33** A number of the respondents were concerned about the tax treatment of spinouts created before the Pre-Budget Report announcement of this measure on 2 December 2004.

**B.34** We have taken a proportionate response to the issue. We understand about 90 spinouts went ahead between April 2003 and December 2004. Some spinouts that went ahead before 2nd December 2004 used “safe-harbour” structures agreed by the Revenue, which would not produce a charge to income tax and NICs unless and until the spinout was a success and there was money to fund the charge. Around 70 may have used structures potentially incurring an up-front liability to income tax and NICs. We have given those the opportunity to elect to defer any charge until the spinout is a success, in line broadly with what would have happened if one of the “safe harbour” structures had been used.

### **Contact Point**

**Copies of responses to the Consultation can be requested by contacting:**

Hasmukh Dodia

Employee Shares and Securities Unit (ESSU)

Room G49

1 Parliament Street

London

SW1A 2BQ

Tel: 020 7147 2839

E-mail: [Hasmukh.Dodia@ir.gsi.gov.uk](mailto:Hasmukh.Dodia@ir.gsi.gov.uk).

## List of Respondents

University of Newcastle upon Tyne  
University of East Anglia  
Durham University  
University of Hull  
Middlesex University  
King's College London  
University of Manchester  
Brunel University  
University of Teesside  
University of Reading  
University of Edinburgh  
Cranfield University  
University of Southampton  
University of Oxford  
Lancaster University  
Imperial College London  
Bournemouth University  
University College London  
University of Warwick  
University of Wolverhampton  
University of Liverpool  
Liverpool John Moores University  
Newcastle University  
University of Cambridge  
University of Manchester Intellectual Property Ltd  
University of Glasgow  
University of Luton  
University of Leicester  
Goldsmiths University of London  
University of Bath

Partnerships UK

Wellcome Trust

Rawlinson & Hunter

Dickinson Dees

Grant Thornton

Ernst & Young

KPMG

CMS Cameron McKenna

One North East Regional Development Agency

PriceWaterhouseCoopers

Deloitte

Speechly Bircham

Garbutt Elliott

Charles Russell

Osborne Clarke

Royal Society of Edinburgh's Enterprise Fellowship Programme

IP2IPO

CBI

CIOT



# RIA - THE EUROPEAN COMPANY STATUTE, ISSUED BY DTI (OCT 2003 CONSULTATION DOCUMENT)

## Purpose and Intended Effect of the Measure

### *The Policy Objective*

**C.1** The European Company Statute (ECS) creates a legal framework for a new form of company, the European Company or 'Societas Europaea' (SE). The ECS consists of a Regulation setting out the core company law framework and an accompanying Directive that specifies the employee involvement arrangements that would apply to an SE. The new form of company - which will be a European public limited liability company registered in one of the Member States with a minimum share capital of EUR 120,000 and having legal personality - will be available to commercial bodies with operations in more than one Member State. Its use will be entirely voluntary.

**C.2** The domestic legislation facilitating the operation of the SE (see paragraph C.10 below) will apply in Great Britain.

**C.3** Since forming an SE will be entirely voluntary only those companies, which perceive that there is likely to be a real benefit, will consider forming an SE. The ECS has created a framework by which GB companies will be able to engage in cross-border mergers with companies from other Member States. At present, there are no harmonised rules in the EU governing cross-border mergers.

**C.4** Secondly, a GB company wishing to take over a company from another Member State, or wishing to establish a joint venture with a company in another Member State, might find it easier to reach agreement with the overseas company if it decided to form a joint holding company or joint subsidiary in the form of an SE.

**C.5** Thirdly, a GB public company wishing to operate in several Member States simultaneously might consider that there were presentational advantages in adopting the SE name and form. The name of an SE will be preceded or followed by "SE" and only SEs will be permitted to include the abbreviation SE in their name.

### *Background*

**C.6** There is five methods of forming an SE set out in the Regulation, as follows: -

- by the merger of PLCs provided at least two of them are governed by the laws of different Member States;
- by the formation of an SE as a holding company for public or private limited companies from at least two different Member States;
- by the formation of an SE as a subsidiary of companies from at least two different Member States;
- by the transformation of an existing PLC which has, for at least two years, had a subsidiary in another Member State; and
- by the formation of subsidiary SEs where an SE is the parent.

**C.7** The Regulation provides that once an SE has been formed, by any method, it may transfer its registered office from one Member State to another without the winding up of the SE or the creation of a new legal person. In addition, an SE may

convert to a PLC although not for at least two years (or before the first two sets of annual accounts have been produced). Conversion to a PLC would not result in the winding up of the company or the creation of a new legal person.

**C.8** The accompanying Directive sets out requirements for the information, consultation and participation of employees (“employee involvement”) in European Companies. All SEs must have employee involvement arrangements. These will always cover information and consultation, and may cover employee participation on the board in certain circumstances (in particular, if it existed within one or more of the participating companies). Before registration of the SE is possible, provision for employee involvement in the SE must be agreed.

**C.9** The Regulation was adopted by Member States on 8 October 2001 and comes into force on 8 October 2004. It is freestanding and will be directly applicable throughout the European Economic Area (EEA), i.e. Norway, Iceland and Liechtenstein and the 15 Member States of the EU (plus, by the coming into force date, the 10 accession countries). In addition, on many matters, it applies to SEs the national legislation applicable to public companies in the Member State where the SE is registered. For example, GB company law applicable to accounts and to winding up, liquidation and insolvency will be directly invoked by the Regulation. (Article 9 sets out the law and other provisions applicable to an SE, and the respective priority in which they apply.)

**C.10** The Regulation lays down a number of Member State options and new domestic legislation will be required to set out the options adopted. This domestic legislation will also need to provide, as set out in Article 68 of the Regulation, for the effective application of the Regulation in GB such as requiring that documentation relating to the new procedures for registering an SE be filed at Companies House. It will also set out the sanctions and penalties for contraventions of the Regulation. The domestic legislation - which will also come into force on 8 October 2004 - will also implement the employee involvement Directive.

### ***The Risks Being Addressed***

**C.11** In the context of both the existing law and the law as amended by the regulations there is no perceived hazard or situation which would lead to any harm or detriment to any individual, company or organisation.

### **Options**

**C.12** As noted above, the Regulation is directly applicable throughout the EEA. All Member States will need to provide for its effective application within their territory. In addition, all Member States will need to implement the accompanying employee involvement Directive. In respect of the Regulation, there are 31 Member State options.

**C.13** The approach of GB in deciding which options to adopt is in general to apply a light touch, ie to impose the minimum duties and costs on companies seeking to form, or convert to, SEs. In other cases, the approach adopted has been to align the provision in the Regulation with the existing law set out in the Companies Act 1985 such as providing that SEs must have a minimum of two directors but not to prescribe a maximum number. There are also 11 requirements on Member States to legislate, which relate mainly to the publicising of documents by companies intending to become SEs. The approach adopted by GB in this respect is to introduce measures, which

reflect the measures already implemented for domestic mergers (in GB these are also set out in the Companies Act 1985).

**C.14** The principal option in the Regulation, as far as GB is concerned, is that set out in Article 39(5). Under this option, a Member State may adopt appropriate measures in relation to SEs where no provision for a two-tier system is made in its plc law. While the Companies Act 1985 dictates neither a one-tier or two-tier board, its provisions generally assume a unified structure.

**C.15** However, there is nothing in law that presently prevents PLCs incorporated in GB from adopting articles under which the powers that are granted are divided between two tiers of directors, one exercising management functions and the other exercising a supervisory role in relation to those functions. Special provision for two-tier boards might create greater certainty in respect of what the law required of SEs since less consideration would need to be given to the interaction between the Regulation, existing company law and the new domestic legislation. However, creating special provision for the board structure of SEs would be prescriptive and less flexible.

## Benefits

**C.16** Since forming an SE will be entirely voluntary, only those companies which perceive that there is likely to be a real benefit will consider forming, or converting to, an SE. Quantification of that benefit is not possible, not least because it is not possible to assess the likely take-up of the SE form by GB companies. It would be helpful if companies that are considering setting up an SE could offer an assessment of the financial advantages of the benefits summarised here.

**C.17** The ECS has created a framework by which GB companies will be able to engage in cross-border activities with companies from other Member States. Secondly, a GB company wishing to take over a company from another Member State, or wishing to establish a joint venture with a company in another Member State, might find it easier to reach agreement with the overseas company if it decided to form a joint holding company or joint subsidiary in the form of an SE.

**C.18** This might prove more acceptable to the “target” company than a straightforward takeover of it by the GB company. Thirdly, a GB public company wishing to operate in several Member States simultaneously might consider that there were presentational advantages in adopting the SE name and form. The name of an SE will be preceded or followed by “SE” and only SEs will be permitted to include the abbreviation SE in their name.

**C.19** Companies adopting the SE vehicle will, under the Directive, have to embrace employee involvement. Economists have argued that information and consultation, together with other types of employment relations practices, acts to align better the interests of companies and workers, thus improving a company’s performance, through lower employee turnover and higher productivity. By being consulted, employees may feel more committed to the organisation and may feel more secure in their jobs.

**C.20** As the benefits of information and consultation will depend very much on the circumstances of the company, the flexibility of options is likely to mean a greater chance of realising benefits. Companies and employees will be able to agree their employee involvement arrangements, taking into account their unique requirements and existing set of arrangements.

## Business Sectors Affected

**C.21** All business sectors are affected since any company may form or convert to an SE if it fits the criteria set out in Article 2 of the Regulation (referred to above). Any two GB companies, public or private, may promote the formation of a holding or subsidiary SE as long as each company has its registered and head offices within the Community and both have had a branch or subsidiary in another Member State for at least two years. In addition, public companies, which fit these criteria, may convert to an SE. The resulting SE must have a minimum share capital of EUR 120,000.

**C.22** It is estimated that there are less than 5,000 companies registered in GB, which fit this criteria. A public company which has its registered and head office within the Community may form an SE by merger as long as the other company involved is governed by the law of a different Member State and the resulting SE has a minimum share capital of EUR 120,000. There are almost 12,000 public companies registered in GB and given that the minimum share capital of a public company in GB is £50,000 all such companies could, potentially, merge with another company in the Community to form an SE.

## Equity and Fairness

**C.23** The ECS is voluntary and only those companies, which perceive that there is an advantage to them, will consider forming, or converting to, an SE. In the light of this, the principal issue of equity and fairness, in theory at least, is whether the restriction of some of methods of forming SEs to public companies, together with the requirement to have a minimum share capital of 120,000 euros might be seen as a barrier to small companies operating across EU borders.

**C.24** It is important to note that private companies can form SEs under the Regulation – it is merely that not all the possible methods are available to them. Moreover, companies with operations large enough to warrant the special form of an SE to carry out cross-border activities are likely to be able to meet the minimum share capital requirement. That minimum requirement reflects a general distinction in EU law between the treatment of public and private companies.

**C.25** Nevertheless, comments on whether the requirements of the Regulation might disadvantage small companies would be welcome. In this context, it is worth noting that the European Commission is considering whether there is justification for the creation of a new form of European Private Company, along the lines of the European Company Statute.

## Costs

**C.26** Since adoption of the SE form is voluntary, no costs will be imposed on any company. It is reasonable to assume that, in the event that a company chooses, voluntarily, to become an SE, the resulting benefits to it will outweigh the costs. Such costs would include, where necessary, the setting up of employment involvement structures.

**C.27** The principal costs incurred by a company where there would not be any benefits would be in the case where a company investigated the possibility of, but ultimately decided against, becoming an SE. In respect of those companies that could convert to an SE, there would appear to be three stages in this process. Firstly, it would seem likely that a senior employee would consider whether there was a case for

conversion to an SE. If this was thought to be a viable proposition then the issue is likely to be put to the company's board. If the company's board were to be persuaded of the viability of the SE form then it is likely that legal advice would be sought. The cost of such legal advice would clearly vary on a case by case basis and be determined, at least initially, on the type and extent of the advice sought by the company.

**C.28** Any attempt to cost the above exercise is fraught with difficulties. However, in respect of the first stage, the cost of a manager spending two days (sixteen hours) considering whether there was a case for conversion to an SE is estimated to be around £400. If it is assumed that 20 per cent of the 5,000 companies referred to in paragraph 13 above undertook this exercise the cost to GB business would be £400,000.

**C.29** In respect of the second stage, a company board of 12 members considering the issue for two hours would represent a further 24 hours of costs with an estimated total cost of £600. If it were assumed that 10 per cent of those 5,000 companies undertook this exercise the cost to GB business would be £300,000. Trying to assess legal costs is even more difficult since, as noted above, they would clearly vary on a case-by-case basis. However, the cost of a solicitor spending one day (eight hours) considering whether a company might benefit from adopting the SE form is estimated to be £2,400. If it were assumed that 5 per cent of the 5,000 companies undertook this exercise the cost to GB business would be £600,000.

**C.30** Companies will not merge with others simply to become an SE. What may happen is that where, say, a GB registered company intended to merge with a German company both companies would consider whether the resulting company should be an SE. In other words, the possibility of forming an SE would be considered as part of the merger process and if this additional option was considered to be the cheapest option, or would result in greater flexibility, it is likely that it would be adopted. The only costs incurred by the companies concerned would be similar to those identified above, i.e. where adoption of the SE form was considered (in this case by a minimum of two companies) but ultimately rejected.

### ***Employee Involvement***

**C.31** In the event that companies decided to use an SE as the vehicle for a merger it is likely that the principal additional costs would come from the employee involvement arrangements. However, the voluntary nature of becoming an SE, as well as the many different circumstances of the companies involved make it very difficult to come up with an estimate of the overall costs.

**C.32** Some illustrative costs are set out below which are based on the merger of two companies of a similar size, one in GB and the other in another EU country, intending to register as an SE in GB. Costs may be higher if there are more than two companies involved. The examples used below assume that there are no subsidiaries and all the employees of each company are located in each of their two respective Member States.

**C.33** For the purpose of agreeing arrangements for employee involvement, a Special Negotiating Body (SNB), made up of employee representatives from the participating companies and any "concerned" subsidiaries, must be established. Any expenses relating to the functioning of the SNB, and to the negotiations in general, must be borne by the participating companies (this may include the cost of up to one "expert" to assist the SNB). The SNB and management have six months, extendable to 12 months, in which to reach a voluntary agreement on employee involvement under Article 4 of the Directive. There are three possible outcomes: -

- the SNB and the management draw up a voluntary agreement for employee involvement under Article 4; or
- the SNB takes the two-thirds majority decision under Article 3.6 of the Directive to rely on the national Information and Consultation rules already in force in the Member State in which the SE has employees (this option is not available where the SE is to be formed by transformation or the company previously had employee participation); or
- no voluntary agreement is reached by the end of the negotiating period and the Article 3.6 decision is not taken but the participating companies still wish to go ahead and register the SE. In such a case, the standard “fallback” rules of the Member State in which the SE wishes to register will apply.

### ***Ballots to Elect SNB Members and Number of SNB Representatives***

**C.34** A ballot must be conducted to elect SNB representatives for the GB employees. Separate ballots may need to be conducted in each Member State where the participating companies or subsidiaries have employees although this will not always be the case. In some Member States (such as Germany), existing works council members may simply be appointed as SNB members and no ballots would be held.

**C.35** The cost of conducting a ballot to elect the GB SNB members is estimated to be around £13,650. There would be no additional balloting cost in the other Member States where the works council is used to nominate its SNB members.

**C.36** The rules for the composition of the Special Negotiating Body (SNB) depend on a variety of factors including the number of participating companies or “concerned” subsidiaries and in how many Member States the employees are located and in what proportion etc. The method of determining the number of SNB members in the Directive implies that there will always be a minimum of 10 SNB members and currently, with the 18 countries of the EEA covered by the Directive, an absolute maximum of 27.

### ***Costs of a Special Negotiating Body Meeting***

**C.37** Assuming that the participating companies have a total of 50,000 employees, an SNB might have ten employee representatives and six management representatives. The costs of this meeting would include the opportunity cost of the workers’ and employers’ time, travel costs, the cost of the venue and interpreter costs. It is estimated that the costs for one meeting would be about £24,000.

### ***Illustrative costs***

**C.38** Three cases, where both companies have information and consultation processes in place, are set out below:

#### ***Case 1***

**C.39** The two merging companies are satisfied with their respective information and consultation arrangements and do not choose to have a transnational body (in effect, an European Works Council (EWC)) in addition to their existing national information and consultation structures.

## **Case 2**

**C.40** Two merging companies want a transnational body in addition to their existing national information and consultation structures and they can reach a voluntary agreement to this effect.

## **Case 3**

**C.41** The two merging companies want a transnational body in addition to their existing national information and consultation structures but they cannot reach a voluntary agreement and so go down the fallback route.

**C.42** In case 1, it is assumed that it takes two SNB meetings for the representatives to take the decision under Article 3.6 of the Directive to rely on the national information and consultation rules already in place in their own countries (i.e. to agree not to supplement their existing agreements). This would cost about £48,000.

**C.43** In case 2, it is assumed that it takes 4 SNB meetings to come to a voluntary agreement, at a cost of £88,000. The voluntary agreement is such that each company in the merger has to make some changes to its existing information and consultation agreements, equivalent to having one or more meetings of a transnational consultative committee a year. This will cost about £64,000 each year.

**C.44** In case 3, it is assumed that failure to reach a voluntary agreement is time consuming and could take 6 to 8 SNB meetings, with a cost of about £143,000 to £190,000. The information and consultation structure set up under the fallback arrangements is likely to be quite similar to that in case 2.

## **Participation at Board Level**

**C.45** If one of the merging companies already has worker participation on the company board, there will need to be at least the same level of participation on the SE board (unless the SNB take a two-thirds majority decision to reduce, or even abolish, employee participation in the new SE). Since there is no tradition of employee participation in GB, the possible costs involved have been estimated using the German model as an example.

**C.46** The maximum percentage of representatives is likely to be 50 per cent of the board as this is the maximum that applies in Germany; it is doubtful that this percentage would be exceeded. In this example it is assumed that there are two worker representatives on the board of the company in the non-GB company and that the SNB decides that there should be four – two from each country. This would mean an extra two worker representatives attending maybe 12 meetings per year, which take up one day of each representative's time. The cost of travel has been included, but not interpreter and venue costs (since these costs will already have been included). It is estimated that this will cost about £15,000 per year.

**C.47** In Germany, a proportion of the employee representatives on the boards of companies may be full time union representatives who are paid by the company for this purpose. If this model were followed for SE boards, there would be no opportunity costs to companies of employee time for these representatives.

**C.48** It is sometimes argued that worker participation on boards can slow down decision-making and hence reduce companies' competitive edge. However, evidence from Japanese companies with works councils in Germany does not show this to be the

case. Accordingly, no costs have been factored in for longer decision-making processes.

**C.49** Once the employee involvement arrangements have been put into place, compliance is likely to follow similar rules and procedures to those set out in the Transnational Information and Consultation of Employees (TICE) Regulations, which implement the European Works Council Directive. There will therefore be costs to employers if a complaint is brought before the Central Arbitration Committee (CAC) or an Employment Tribunal.

**C.50** The costs of appearing at the CAC is estimated to be £11,900 and consists of the average cost of a CAC case together with the cost of two days of management time and one day of employee representative time. The costs of appearing at an Employment Tribunal are £2,540 and consist of £2,000 for the employer and £540 for the Employment Tribunal Service.

### Small Firms' Impact Test

**C.51** The key point is that adoption of the SE form will be voluntary and no costs will be imposed on small firms. Although the minimum share capital of an SE will be EUR 120,000, it will nevertheless be open to smaller companies to form an SE if the other companies involved have sufficient share capital.

### Competition Assessment

**C.52** The new domestic legislation will affect all markets since formation of an SE is not restricted to any particular sector. This legislation will not impose additional costs - either set-up or ongoing - on any companies nor restrict the ability of companies to choose the price, quality, range or location of their products. It is anticipated that the legislation will not affect competition, either positively or negatively. However, it is possible that the legislation will have an effect on market structure since the formation of SEs by merger could (but not necessarily would) lead to a smaller number of GB registered companies although this could be off set by the creation of subsidiary or holding SEs registered in GB. The number of companies registered in GB would not, of course, be affected by the ability of public companies to convert to SEs.

### Enforcement and Sanctions

**C.53** Enforcement of existing company law and legislation dealing with the involvement of employees (such as European Works Councils) - which are both subject to criminal penalties for non-compliance - is the responsibility of the Department of Trade and Industry. The Department will be responsible for enforcing the ECS other than certain provisions in the Regulation that fall to the Court. The principal role for the Court will be to issue a certificate certifying that the pre-merger acts and formalities have been properly completed where an SE is being formed by merger and, subsequently, for it to scrutinise that the merger has been properly completed and the SE correctly formed.

### Consultation

**C.54** The consultation document will be placed on the Department's website and will also be sent to all organisations that have responded to the Department's previous consultations on this issue (both the Regulation and the Directive) and other organisations known to have an interest in the ECS. The Department has consulted the

Department for Constitutional Affairs, the Office of the Lord President, the Inland Revenue and, in Northern Ireland, the Department of Employment and Learning and the Department for Enterprise, Trade and Investment. It also held meetings prior to the publication of the consultative document with the Law Society, Confederation of British Industry, Trades Union Congress and Takeover Panel.

### **Monitoring and Review**

**C.55** The Department will keep the ECS under review. If, in the light of experience, it proves necessary to amend the domestic legislation this could be done by making further regulations under section 2(2) of the European Communities Act 1972. However, the consultation exercise will give interested parties the opportunity to comment on the draft legislation.

First published in October 2003. Department of Trade and Industry. © Crown Copyright. URN 03/1279 <http://www.dti.gov.uk/>