

**Large Business Taxation:
The Government's strategy
and corporate tax reforms**

A consultation document

HM Treasury
Inland Revenue
July 2001

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CONTENTS

	Page
Foreword	
1 The Government's strategy	1
2 The taxation of the returns from substantial shareholdings	9
Annex A: Exemption for gains and losses on substantial shareholdings	13
Annex B: Exemption of foreign dividends	17
Annex C: Deferral relief for gains on substantial shareholdings	21

Foreword

Four years ago, we set out our central economic aim of achieving high and stable levels of growth and employment. In the last Parliament, we put in place reforms to achieve macroeconomic stability and to promote work.

In our second term, we have set ourselves the target of creating a new Britain based on enterprise for all. Last month, we announced reform and modernisation of product, labour and capital markets aimed at boosting Britain's productivity. This included a series of tax reforms to help small and growing businesses. These cut the effective rate of capital gains tax on business assets to 10 per cent after two years, proposed doubling the size of firms that can qualify for Enterprise Management Incentives, and extended our strategy for supporting new and small firms, including a commitment to widen the 10 per cent corporation tax band.

The Government also recognises the important role played by larger businesses, many of which operate on a global scale, in creating wealth, enhancing competition, promoting innovation and spreading best practice across national boundaries. The increasing openness and integration of the world economy, combined with the substantial reduction in the costs of communications, means that multinational businesses are likely be of increasing importance in the world economy.

The UK has long been a hub for global business. There are many factors that make the UK particularly attractive, including our sophisticated financial markets and our strong trading links with all parts of the world.

To ensure this remains the case, it is essential that the corporate tax system keeps pace with changes in the global business environment, complementing business competitiveness, not stifling it. The tax system should facilitate decision-making that is driven by commercial factors, rather than by tax considerations. And we will work, together with our international partners, to ensure fair competition, which is not distorted by artificial tax advantages. But Government should use the tax system, where appropriate, to tackle market failures, to help close the productivity gap and to support our objective of high and stable levels of employment and growth.

We recognise the importance of consultation in creating a modern corporate tax regime that will provide stability for business in the longer term. This consultation sets out the Government's strategy for modernising the corporate tax system, the choices we have made since 1997, and takes forward the Government's proposals on the taxation of returns from companies' substantial shareholdings.

The system we inherited in 1997 needed urgent reform. We therefore chose to embark on a series of reforms, centred on a tax system with low tax rates combined with a broad tax base. We cut the main corporation tax rate from 33 per cent to 30 per cent, its lowest ever rate. We removed tax distortions that affected investment decisions. We also took out of the system unnecessary rigidities that imposed administrative burdens and unwieldy structures on business.

This document focuses on the next stage of these reforms. We are designing a new relief for corporate capital gains to facilitate the process of restructuring and reinvestment, helping business take advantage of emerging global opportunities. We believe that the proposed exemption approach has substantial attractions, a view shared by business during the initial consultation. While some have advocated that we should follow the continental European model of exemption more widely, such as for foreign dividends, we believe that the

current system of taxing such dividends, based around a credit for foreign tax, offers a better way forward for UK business.

Our programme of reform embodies the spirit of fair tax competition, levelling the playing field and creating a framework in which business can thrive, whilst taking into account wider concerns, such as the impact of economic activity on the environment.

This consultation is another essential step towards a more modern, more flexible and more efficient tax system that will provide the stability that business needs to invest for the future.

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

Rt Hon Gordon Brown MP

THE GOVERNMENT'S STRATEGY

INTRODUCTION

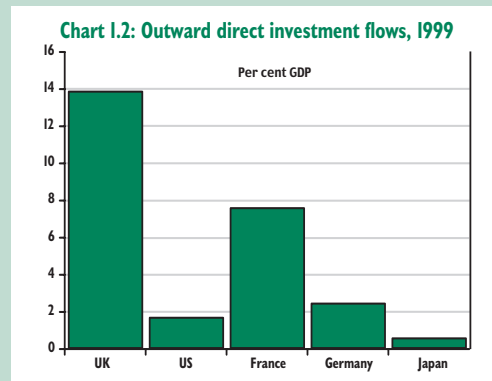
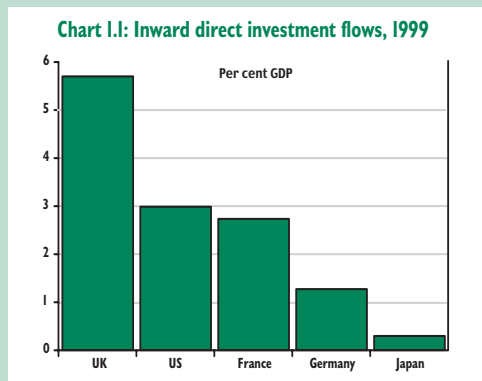
1.1 Large businesses, many of which operate on a global scale, play a vital role in the economy – creating wealth, enhancing competition, promoting innovation and spreading best practice across national boundaries.

1.2 The UK today is a very attractive location for business, with strong international links and high levels of both inward and outward investment. The Government is committed to ensuring that this remains the case, by creating the best possible environment for long-term business investment, both in and from the UK. Corporate taxation is a key element of this environment.

1.3 The Government is therefore creating a modern corporate tax regime that will provide stability for business in the longer term. This chapter sets out the Government's strategy for modernising the corporate tax system and the policy objectives underpinning the reforms made since 1997. Chapter two takes forward the Government's proposals on the taxation of returns from companies' substantial shareholdings. This document invites comments from business, the professions and other interested parties on the proposed way forward.

Box 1: Inward and outward investment

Relative to our GDP, the UK attracted more foreign direct investment (FDI) in 1999 than any other major economy, 27 per cent of the total FDI into the EU. Research has shown that inward investment has accounted for up to 30 per cent of productivity growth in UK manufacturing.^a The UK also made more outward investment than any of our major competitors.



Source: UN World Investment Report, 2000

Globalisation is highly apparent in the growth of these investment flows. In money terms, world FDI flows increased from \$210 billion in 1990 to \$865 billion in 1999. And the UK stock of inward and outward investment has increased dramatically over the last ten years to the first quarter of 2001; from £115 billion to £340 billion (20 per cent to 36 per cent of GDP) for inward investment, and from £120 billion to £640 billion (22 per cent to 68 per cent of GDP) for outward investment, with the main sources and destinations being the US and the EU.^b

^a Barrell, R. and Pain, N. (1997), *Foreign direct investment, technological change and economic growth within Europe*, The Economic Journal, Vol. 107.

^b Source: UK Balance of Payments (ONS June 2001).

THE GOVERNMENT'S STRATEGY FOR MODERNISING CORPORATE TAXES

1.4 In July 1997, the Government set out the basic principles of its taxation policy. The tax system needs to

- raise sufficient revenue for the Government to fund public services and to service debt; and
- ensure fairness between all stakeholders in the UK economy, so all sections make a fair contribution to the future of the UK.

1.5 Within this framework, the Government is committed to creating the best possible location for investment, keeping taxes on business as low as possible and ensuring that the tax system reflects the realities of the modern business environment. The key principles for corporate tax reform are competitiveness and fairness.

1.6 Business competitiveness. To create the best possible location for investment, the tax system should complement business competitiveness, not stifle it. This means:

- removing tax distortions, facilitating decision-making that is driven by commercial factors, rather than by tax considerations. Businesses, not government, are best placed to judge how to operate and structure themselves; and
- promoting productivity by tackling market failures that ultimately undermine growth, such as under-investment in research and development.

1.7 Fairness. But competitiveness needs to be balanced by fairness. This means:

- ensuring individual businesses pay their fair share of tax in relation to their commercial profits and compete on a level playing field; and
- if the tax system is the best policy instrument, using it to correct market failures that impose wider costs on society.

THE CHANGING BUSINESS ENVIRONMENT

1.8 The business world has changed greatly since the previous major corporate tax reforms in the mid-1980s. Globalisation has altered the scale of business. The increasing openness and integration of the world economy, combined with the reduction in the costs of communications, means that multinational businesses are likely to increase in importance.

1.9 Business structures have evolved. There has been a sharp rise in merger and acquisitions activity, alongside the increased use of joint ventures for highly capital-intensive projects.

1.10 And the nature of what companies do has changed. The last ten years have witnessed huge technological change, with knowledge and ideas as important now as traditional business assets like plant and machinery.

1.11 Governments around the world face the same challenges as the UK. Ignoring these challenges would result in missed opportunities and in a failure to reap the rewards of the global marketplace. Positive action and working with other countries will allow fair tax competition to flourish and business to exploit real commercial opportunities.

Box 2: Multinational business and globalisation

The largest businesses operating in the UK tend to be multinational enterprises. There has long been a trend to organise basic manufacturing on an international basis, seeking the most competitive location taking into account a wide range of factors that influence productivity and costs. The UK has had a good record in inward investment of this type, attracting over one-quarter of all direct investment into the EU in 1999 (see Box 1).

The increasing openness and integration of the world economy and reductions in communication costs have helped these businesses expand to address issues on a globally coordinated basis rather than the historical localised approach. This has resulted in the international organisation of many central business functions, such as group treasury, IT, research and development, headquarters and regional sub-headquarters. The UK attracts half of all new European headquarters projects, with headquarters alone accounting for 15 per cent of all new inward investment into the UK.^a Headquarters tend to cluster in major cities and the strength of London as a base for company headquarters is tied to its importance as a financial centre, with enormous depth of resources in fund management and corporate finance. The globalisation of capital markets may be strengthening these clustering effects.

The sharp rise in merger and acquisition activity is also particularly significant, as it is usually associated with some restructuring and consolidation of business functions, and so creates a global market for business location. Cross-border mergers and acquisitions have risen in money terms from \$150 billion in 1990 to over \$700 billion in 1999, including 109 cross-border deals of over \$1 billion each. With the continued integration of the world's economies it is likely that multinational business will increasingly be geographically mobile.

^a Source: European Investment Monitor, Ernst and Young.

TURNING PRINCIPLES INTO PRACTICE SINCE 1997

I.12 In 1997, the Government chose to modernise the corporate tax system. The alternative would have been to continue to let it stagnate in the face of a rapidly changing global business environment. This would have damaged employment, created ever increasing barriers to economic growth and moved the system further away from achieving the principles of competitiveness and fairness set out above. Looking at the tax system inherited by the Government in 1997, the key objectives for turning these principles into practice were:

- **maintaining a low rate, broad base system.** Low rates and a broad base facilitate decision-making that is driven by commercial factors, while better aligning taxable and commercial profits;
- **reducing tax distortions and market failures.** In 1997, there were major tax distortions to business decisions, such as where to invest and whether to retain profits, while the UK tax system was not being utilised effectively to tackle market failures even when it was the best policy instrument available;
- **removing outdated and ineffective restrictions.** The UK system contained a number of provisions that imposed unnecessary administrative costs for little or no tangible benefits. Such restrictions often placed constraints on businesses' ability to restructure and reinvest; and
- **countering tax avoidance.** There is always a need for government to ensure that firms pay their fair share of tax and do not gain an unfair competitive advantage through artificial tax planning.

I.13 At the same time, long-term investment requires stability. And this implies the need for a transparent reform process:

- business should be able to plan for the future in the knowledge of a clear direction for policy. This is an important complement to the macroeconomic stability of the last four years; and
- the reform process should be built on consultation so that business has the opportunity to make an effective contribution that will help to ensure that the reforms themselves achieve the Government's objectives.

THE REFORM PROGRAMME SINCE 1997

Maintaining a low rate, broad base system

I.14 At the heart of the Government's programme was the reduction in the main rate of corporation tax from 33 per cent to 30 per cent during the last Parliament. The UK now has its lowest ever rate and the lowest rate among major industrialised countries.

I.15 The tax base also needed to be modernised. For example, intangible assets are of growing importance in a knowledge-based economy. The available reliefs for business expenses did not recognise this and there was no coherent system for relieving the costs of such assets. So new reliefs have been introduced, such as relief for the cost of purchasing third generation mobile phone licences. And the Government has proposed a comprehensive regime that will provide a lasting solution for all intangible assets.

Reducing tax distortions and market failures

I.16 At the same time as cutting the rate of corporation tax, the Government took steps to remove tax distortions:

- **Abolition of Advance Corporation Tax (ACT).** ACT caused investment decisions to be driven by tax rather than commercial factors. Previous attempts at reform had not provided a durable solution, so ACT was abolished from 1999. ACT had been used ineffectively as a proxy for ensuring that companies paid tax during the year, so the Government consulted business and introduced a more efficient collection regime with quarterly payments on account for large companies.
- **Removal of payable tax credits on dividends.** The system of tax credits encouraged companies to pay out profits rather than to retain them in the business for reinvestment. To remove this distortion payable credits were abolished.

I.17 The Government is also tackling market failures:

- **Research and Development tax credit.** The Government has consulted businesses on the design of a new research and development (R&D) tax credit aimed at encouraging innovation by large companies in recognition of the wider benefits to the economy that flow from R&D expenditure, building on the experience with the SME regime.

- **Environmental measures.** The Government has introduced a series of measures to recognise the social costs of environmental pollution. Using taxes to include the costs to society from pollution within prices creates greater economic efficiency. The Government has balanced changes such as the introduction of the climate change levy by reductions in employer national insurance contributions and spending programmes so as to be revenue neutral overall for the private sector.

I.18 The Government has also sought to eliminate tax distortions arising from artificial tax incentives that have been available on an international level. There is a need for cooperation between countries to guard against abuse and to ensure fairer global competition. The UK continues to work in international fora, such as the OECD and the EU Code of Conduct Group, to promote fair tax competition.

Removing outdated and ineffective restrictions

I.19 The Government has removed various unnecessary restrictions that simply produced administrative burdens for business or constrained their ability to restructure to meet emerging commercial opportunities:

- **More flexible group reliefs.** With business increasingly organised on an international scale, the rules governing the transfer of assets and the use of tax losses within multinational groups contained outdated restrictions that hampered business. So these rules have been liberalised to give groups the flexibility to structure themselves in the way that best suits their commercial needs.
- **New onshore pooling system.** The way that relief is given for foreign tax on dividends received by UK companies has been changed to allow onshore pooling of dividends, so groups can now get maximum relief for foreign taxes without the need to arrange their holdings of overseas subsidiaries through complex offshore structures. As part of these reforms, effective anti-avoidance rules have been introduced to ensure that new reliefs intended to enhance business competitiveness are not abused. So, for example, dividends arising from offshore companies used to divert profits from the UK are excluded from the new system.
- **Removal of withholding taxes.** Withholding taxes can impose a high burden on business, often resulting in one company withholding and another reclaiming tax. Where these rules have proved unnecessary, such as for intra-UK corporate interest payments, Eurobonds and gilts, the Government has abolished them.

Countering tax avoidance

I.20 The Government has moved against a number of artificial tax avoidance schemes to ensure that companies pay their fair share of tax and do not gain an unfair competitive advantage. For example, the Government legislated in 1998 to prevent the practice of 'gain buying', where groups offset losses against gains which had arisen in different ownership. Countering artificial tax avoidance in the UK corporate tax environment will remain a priority.

THE NEXT STEPS

1.21 The Government is continuing to reform and modernise other aspects of the corporate tax system to reflect changes in the business environment:

- Detailed consultation has been held with business on the new regime for all intangible assets, which are of growing importance in the emerging knowledge-based economy. This will continue the modernisation of the UK tax base, and the Government wishes to ensure that the new regime can be introduced as soon as is practicable.
- The Government is taking forward the design of the R&D tax credit for large companies, to tackle the market failures that reduce such spending. Having consulted, the Government intends to introduce a tax credit in the next Budget.
- The Government is also examining the corporation tax treatment given in respect of employee share awards and share options, including whether a corporation tax deduction should be made available and how access to it could be streamlined.

1.22 This consultation document specifically takes forward the Government's proposals on the taxation of capital gains on disposals of companies' substantial shareholdings. Most large businesses, particularly multinationals, are organised into groups of companies. At present, when groups wish to restructure for commercial reasons, they may crystallise large tax charges on any resulting capital gains, charges that would not occur if they did not restructure. This can lead to essential business decisions on restructuring and reinvestment being constrained by the tax system. For many multinationals, this encourages the adoption of complex, offshore structures that add unnecessary administrative burdens.

1.23 The Government has put forward two options, one based on a deferral approach, the other on an exemption. The Government believes that the exemption approach has substantial attractions, a view shared by business during the initial consultations. The Government is now putting forward more details of how an exemption would operate so that a full and informed comparison can be made between this and a deferral.

1.24 In considering an exemption for capital gains, wider issues have been raised about the direction for UK tax reform. One possibility that has been raised is a move towards the continental European model, by exempting not only capital gains, but also some foreign dividends. To aid discussion, the Government's initial thinking about what an exemption for overseas dividends might look like is described more fully in Chapter 2. Superficially, a dividend exemption has attractions, particularly in terms of simplification. But some of the gains may be illusory and would need to be balanced with some broader considerations. For example, a change to an exemption would need to consider any implications for the UK's existing double tax treaty network and would have to retain the benefits of the UK's existing international links.

1.25 The Government feels that the current system, based around a credit for foreign tax, offers a better way forward for UK business. With the low corporate tax rate and credit relief for overseas taxation, it often results in little additional UK tax being paid on foreign dividends. Combined with a new relief for capital gains, the Government believes that this system should provide a stable regime for the taxation of substantial shareholdings into the future.

I.26 The new relief for corporate capital gains will facilitate the process of group restructuring and reinvestment, helping business take best advantage of emerging global opportunities. Other aspects of the tax system also impact on these decisions and, as with all taxes, the Government will keep these under review.

ADMINISTRATION AND LINKS TO BUSINESS

I.27 A modern tax system requires a supportive and forward-looking tax administration, balancing regulatory requirements with high quality support. The Government is committed to tackling regulatory burdens and supporting businesses. To champion reform, Lord Haskins' Better Regulation Task Force has been established to tackle regulatory issues across Government. The new Regulatory Reform Act will play a vital role in the drive to reform outdated, overlapping and over-burdensome legislation. Under this Act, over 50 potential reforms have been identified, with six measures out to consultation and one potential regulatory reform order already laid. These seven measures alone – which relate to issues as diverse as renewing business leases and licensing hours – could save businesses £40 million. The Panel for Regulatory Accountability calls departmental regulatory reform ministers to account for their departments' regulatory performance and the Government is committed to publishing Regulatory Impact Assessments for all new measures having an impact on business.

I.28 During its first term, the Government set up the Small Business Service to be a strong voice for small businesses within Government. Now, as part of the Government's review of small business taxation, the Inland Revenue is exploring how support for small companies might be enhanced, particularly through the use of "e" services. At the same time Patrick Carter, a businessman and member of the Government's Public Services Productivity Panel, is reviewing how to improve payroll support for small business.

I.29 The Inland Revenue already operates a number of formal and ad-hoc consultative arrangements with large corporates and their representative bodies. As part of the modernisation of the taxation of large business, the Paymaster General has asked David Hartnett, Head of Revenue Policy, to lead a review of the coverage and effectiveness of the Inland Revenue's links with business on administrative matters, focusing in particular on feedback channels from larger businesses into the operational policy making process. A report will be made to the Paymaster General in October.

CONCLUSION

I.30 Following the essential modernisation undertaken over the last four years, the UK now provides a corporate tax system that is fairer, has fewer distortions and provides a more supportive environment in which companies can meet the challenge of global competition. This contributes to creating a strong environment for long-term investment by business, both in and from the UK.

I.31 The Government intends to continue this process of modernisation. It has set out detailed proposals for a new relief for capital gains on companies' substantial shareholdings. The Government is also prepared to consider the case for reforming the treatment of dividends from foreign countries, though it believes that retaining a credit system, based around the principles in the current legislation, provides the best way forward. The Government welcomes the views of business on these issues.

Contact details

I.32 Responses to the consultation on a new relief for capital gains on substantial shareholdings and related issues should be sent by 1 October 2001 to:

Linda Cooke
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30-34 Kingsway
London WC2B 6ES.

linda.cooke@ir.gsi.gov.uk

I.33 Those wishing to contribute to the Hartnett Review of Inland Revenue's links with business on administrative matters should contact:

Brigit Bracco
Inland Revenue
1st Floor
New Wing
Somerset House
The Strand
London WC2R 1LB

brigit.bracco@ir.gsi.gov.uk

2

THE TAXATION OF THE RETURNS FROM SUBSTANTIAL SHAREHOLDINGS

2.1 The Government has made significant progress in modernising the corporate tax system. It will continue to build on these reforms.

2.2 In the modern world, most large businesses are organised into groups of companies and often operate on a global basis. During its first term, the Government updated parts of the tax system to afford greater recognition of this. The Government now intends to put in place a stable tax regime for substantial shareholdings, both within groups and more widely.

RELIEF FOR CAPITAL GAINS

2.3 At present, when groups wish to restructure for commercial reasons, they may face large tax charges on any resulting capital gains. This can lead to essential business decisions on restructuring and reinvestments being influenced by the tax system. For many multinationals, this possibility also encourages the adoption of complex, offshore structures that add unnecessary administrative burdens. In line with the Government's approach, the solution to this is a comprehensive relief for capital gains on substantial shareholdings, as is already found in other countries.¹ The Government intends to introduce this in Finance Bill 2002.

2.4 The Government has put forward two options for change:

- a relief based on a deferral of the tax charge where the sale proceeds are reinvested; or
- exempting gains, and disregarding losses, from disposals of substantial shareholdings.

2.5 A deferral relief would provide significant benefits to UK companies. Details were set out in Budget 2001 and this remains an option.

2.6 However, business responded positively to the Government's initial proposals for an exemption, particularly stressing that it could afford greater transparency than a deferral and would result in a system that would be in line with many other tax jurisdictions. There would also be no restrictions on how proceeds were used. The Government is now putting forward details of how an exemption would operate, so that a detailed and informed comparison can be made between this and a deferral. The Government believes that the exemption approach has substantial attractions.

2.7 As announced at the time of the Budget, the Inland Revenue will shortly be issuing a consultation document on foreign exchange, financial instruments and loan relationships. The interaction of these rules with any relief for gains on substantial shareholdings will need to be addressed in due course.

¹Austria, Belgium, Denmark, Luxembourg, the Netherlands, Portugal and Spain already operate exemption systems for capital gains on all or some classes of substantial shareholdings. The recent reforms to the German tax system have followed this lead.

2.8 Technical details of the proposed exemption system are set out in Annex A.² Comments are invited both on the relative merits of the exemption and deferral approaches and on the detailed proposals.

THE TAXATION OF FOREIGN DIVIDENDS

2.9 During the initial consultation on an exemption for capital gains, some respondents asked for clarification of the consequences of such an exemption for the taxation of foreign dividends.

2.10 The Government considers that an exemption for capital gains would be compatible with the current system of taxing dividends and that this system offers an attractive environment for business. But it recognises that there are alternative approaches to the taxation of foreign dividends, and these are considered below.

2.11 Internationally, there are two accepted ways of recognising that dividends from foreign companies may have already borne foreign tax:

- charge tax on overseas dividends, but reduce this by giving a credit for foreign tax already paid. This is what the UK does currently, along with Japan, the United States and many other countries; or
- exempt from tax some dividends, in recognition of the foreign tax already paid on those dividends, while generally operating a credit regime for lowly taxed and untaxed dividends. This is, for example, what the French system does.

2.12 The current UK regime, with its low corporate tax rate and relief for double taxation, often results in little additional UK tax being paid on foreign dividends, as the UK tax charge is offset by foreign tax already paid.

2.13 At first sight, an exemption system might appear to offer a simpler way of relieving double taxation. But a full comparison of the two approaches presents a less straightforward picture.

2.14 In line with the Government's approach to corporate taxation and international practice, an exemption system would exclude dividends where little or no foreign tax had already been paid – an exemption is a different means of recognising foreign tax, not a means for dividends to escape tax altogether. This would imply the retention of a residual credit system to tax such dividends.

2.15 Any exemption system would also have to be compatible with the UK's bilateral tax agreements, in order to retain the substantial benefits afforded by the UK's extensive network of double tax treaties.

2.16 The Government feels that the current system, based around a credit for foreign tax, offers a better way forward for UK business. But, to aid discussion, the Government's initial thinking about what an exemption for overseas dividends might look like were such a regime to be introduced is set out in Annex B. The Government invites business to comment on the key aspects of this possible system.

²For convenience, details of the proposed deferral relief are set out in Annex C.

2.17 Many countries with exemption regimes for foreign dividends have rules that aim to restrict the deductibility of interest costs in respect of foreign investment. There is some logic to the position that, in the absence of a formal tax charge, there should be no relief for expenses. But such costs are not easily apportioned in a coherent way between foreign and domestic operations. The rules necessary to achieve this are either difficult to apply, or highly complex, or both. On balance, it is unlikely that any of the proposals set out here would necessitate the introduction of such rules.

2.18 However, the Government remains concerned that the UK's provisions for deducting interest expense should not be open to abuse and will keep the position under review.

CONCLUSION

2.19 This chapter sets out detailed proposals for a new relief for capital gains on companies' substantial shareholdings. Technical details are given in the Annexes. The Government is also prepared to consider the case for reforming the treatment of dividends from foreign countries, though it believes that retaining a credit system, based around the principles in the current legislation, provides the best way forward for UK business.

A

ANNEX A: EXEMPTION FOR GAINS AND LOSSES ON SUBSTANTIAL SHAREHOLDINGS

A.1 This annex sets out in detail the Government's proposals for an exemption from corporation tax for gains and losses arising on disposals of substantial shareholdings.

A.2 The form of the exemption takes as its starting point the proposed deferral relief that has already been the subject of considerable consultation and discussion with business. Details of the proposed deferral relief are set out in Annex C.

Comments are invited generally on the proposals for an exemption.

OUTLINE OF EXEMPTION

A.3 As currently envisaged, gains would be exempt, and losses would not be allowable, where:

- a qualifying shareholder company
- which has held a substantial shareholding in a qualifying investee company throughout a 12 month period
- disposes of any shares in that company.

A.4 There would be no requirement for the proceeds from the sale of the shareholding to be used in any particular way.

QUALIFYING SHAREHOLDER COMPANY

A.5 A qualifying shareholder company is a company which, both before and after the disposal, is:

- a trading company, where it is not a member of a group; or
- any member of a trading group.

DEFINITION OF TRADING COMPANY/TRADING GROUP

A.6 The definitions of 'trading company' and 'trading group' have been discussed in the context of deferral relief, where there has been continuing concern over adopting the definitions used for capital gains tax taper relief. A particular point has been the distinction, in paragraph 22 of Schedule A1 Taxation of Chargeable Gains Act 1992 (TCGA), between the definition of a trading company (which refers to the purpose for which a company exists) and the definition of a trading group (which refers to the activities of the companies in the group).

A.7 The way that the Inland Revenue applies these definitions for taper relief purposes has now been set out in an article in the June 2001 edition of *Tax Bulletin*. This explains that, in determining whether a company is a 'trading company', only those of its purposes that are actually reflected in its activities will be taken into account.

A.8 The Government hopes that the guidance in the *Tax Bulletin* article will have allayed the earlier concerns about using the taper relief definitions for a relief on substantial shareholdings. If the distinction between 'purpose' and 'activities' were still perceived as an issue for an exemption on substantial shareholdings, the Government would be prepared

to consider defining a trading company in terms of its 'activities' for the purposes of this exemption.

QUALIFYING INVESTEE COMPANY

A.9 The qualifying investee company must be a trading company or the holding company of a trading group. Similar definitions will apply for 'trading company' and 'trading group' as apply to the qualifying shareholder company.

A.10 The meaning of 'trade' for the purpose of defining qualifying investee companies will exclude such activities that would, in most circumstances, be considered as trading activities but which are classified as 'investment business' under paragraph 9 of Schedule 25 Income and Corporation Taxes Act 1988 (ICTA). (The meaning of 'trade' for the purpose of defining qualifying shareholder companies will not be restricted in this way.)

WHAT IS A SUBSTANTIAL SHAREHOLDING?

A.11 If a capital gains exemption were to be introduced, but not an exemption for foreign dividends, the proposals envisage that a substantial shareholding would be defined as a beneficial entitlement to at least 20 per cent of the investee company's ordinary share capital, distributable profits, and distributable assets (as amplified by the rules in Schedule 18 ICTA). If, however, a CG exemption were to be introduced alongside an exemption for certain foreign dividends, then there would be a case for aligning the thresholds for the two reliefs. The possible threshold for a dividend exemption is discussed in paragraph B.15 of Annex B.

A.12 Where the qualifying shareholder company is a member of a trading group, it may be possible also to take into account other group members' beneficial interests in the qualifying investee company when determining whether the shareholding is a substantial shareholding. Aggregation of members' interests would be possible at any time when the shares could be transferred between them on a no gain/no loss basis under section 171 TCGA.

A.13 The exemption would be available for part disposals out of a substantial shareholding as well as for disposals of the entire shareholding. A disposal of shares could still qualify for the capital gains exemption even if the threshold requirement were not met at the time of the disposal, as long as a substantial shareholding in the qualifying investee company in question had been held throughout a 12 month period ending within the 12 months prior to the disposal.

A.14 Where a substantial shareholding is held, the exemption would apply for disposals of shares in any class of shares in the company in question. But securities would not qualify, even if a substantial shareholding were also held.

OTHER MATTERS

A.15 Special rules would be needed to deal with share reorganisations. The usual 'stand in shoes' provisions would be disapplied if a gain on the original shares would have been exempt (or a loss would not have been allowable) had those provisions not applied. Rules would also be needed to provide that postponed chargeable gains which are revived on a disposal of shares (e.g. under section 140(4) TCGA) are not able to benefit from any exemption applying to the disposal.

A.16 Discussions will be resumed with companies within the life assurance sector as to how the general approach to exempting gains and losses on substantial shareholdings might be applied to them. Whether an exemption would apply to North Sea companies remains under consideration.

A.17 As part of the package introducing an exemption for gains and losses on substantial shareholdings, the Government proposes that a gain arising under section 179 TCGA (the “degrouching charge”) on a qualifying asset should be capable of being rolled over if another qualifying asset is acquired. Assets that qualify for capital gains business assets rollover relief will be qualifying assets for this purpose, and the other conditions for rollover relief will need to be satisfied. Relief for the section 179 gain may be claimed by the company chargeable under that section or, by virtue of the provisions in section 175 TCGA, by another company in the group of which that company was a member prior to the degrouching event.

A.18 If a capital gains exemption were to be introduced, the Government’s intention is that it should operate symmetrically – i.e. that gains should be exempt and losses not be allowable. If necessary, specific provisions will be proposed to ensure that this result is achieved.

A.19 The Government is also concerned about the potential wider implications of a capital gains exemption for other areas of the UK corporate tax regime, for example, the charge arising under section 185 TCGA on the migration of UK companies.

A.20 An exemption for substantial shareholdings unaccompanied by any parallel revenue protection measures would facilitate changes in companies’ tax residence which were driven more by fiscal than commercial considerations. A significant part of the tax base could then be at risk.

A.21 The Government would be concerned to take the necessary steps to minimise that risk and has identified a number of possible options to provide this protection, taking into account the various steps that other countries that currently exempt gains on substantial shareholdings have taken to protect their tax revenue. Such options would include:

- reviewing UK law and practice on company tax residence to address, for example, cases of artificial or tax-driven changes of residence;
- amending the rules treating dual resident companies as resident outside the UK, so that such companies remain within the scope of the CFC rules;
- examining whether the migration of a company should be treated in the same way as its dissolution for tax purposes (in line with most other EU countries);
- excluding from the benefit of the exemption disposals that were made as part of a tax avoidance scheme.

Views are invited on the merits of these or other options for addressing the Exchequer risk described above.

B

ANNEX B: EXEMPTION OF FOREIGN DIVIDENDS

BACKGROUND

B.1 Internationally, there are two accepted ways of recognising that dividends from foreign companies may already have borne foreign tax (or have been paid out of profits on which foreign tax has been paid):

- charge tax on dividends received by companies, but reduce this by giving a credit for foreign tax already paid. This is what the UK does currently, along with Japan, the United States and many other countries; or
- exempt from tax some dividends received by companies, in recognition of the foreign tax already paid, while generally operating a credit regime for dividends in respect of which little or no foreign tax has been paid. This is what France does, for example.

B.2 The March 1999 Inland Revenue discussion paper “Double Taxation Relief for Companies” presented the economic and technical arguments on these alternative methods of relieving double taxation. This annex considers what a system of exempting some foreign dividends might look like if it were to be introduced in the UK.

A MINIMUM LEVEL OF FOREIGN TAX

B.3 A system for exempting certain foreign dividends in the UK would, of course, have to be consistent with fair tax competition. So it would have to avoid fostering harmful tax competition by encouraging, for example, the use of niche tax regimes outside the UK. And an exemption regime should not tilt the playing field unfairly against investment in the UK.

B.4 This suggests that exemption should apply only to dividends paid into the UK out of profits on which a minimum level of foreign tax has been paid. Dividends that did not meet this “minimum level of foreign tax” test would be taxed in the UK, with a credit for any foreign tax suffered, just as they are now.

B.5 The working assumption might be to mirror the controlled foreign companies (CFC) legislation so that an exemption system for the UK would apply to foreign dividends paid out of profits that had been subject to foreign tax of at least 75 per cent of the UK corporation tax rate (currently up to 30 per cent) – i.e. 22.5 per cent.

B.6 This could be calculated (like the CFC rules) as 22.5 per cent of what the foreign profits would be if they were calculated according to UK tax rules; or as 22.5 per cent of the foreign company’s distributable profits calculated according to the other country’s rules (which is how relief for underlying tax is calculated now under the credit method).

OTHER APPROACHES

B.7 If it was not possible to devise a satisfactory system based on the criterion of a minimum level of foreign tax, other proxies for a “minimum level of foreign tax” test might be easier to apply in practice.

B.8 One approach might be automatically to exempt dividends paid by foreign associates or subsidiaries in specified listed countries – such as those with which the UK has a tax treaty (which until recently was the German approach) or those with tax systems or rates broadly comparable to the UK’s (which is the basis of the Australian approach).

B.9 On the one hand, the sheer size of the UK's tax treaty network, including some with countries with effective tax rates well below the main UK corporation tax rate might make the treaty approach inappropriate. On the other hand, a more sophisticated approach (like that used for the excluded countries test in the CFC rules) would inevitably be very complicated if it were to avoid running the risk of exempting dividends that have been taxed at a rate well below the UK corporation tax rate or been routed into the UK through listed countries.

B.10 Another approach might be to exempt dividends paid out of specified types of profit but to tax others (as France and Canada do) but this could also have high compliance costs for business.

INTERACTION WITH A CAPITAL GAINS EXEMPTION FOR SUBSTANTIAL SHAREHOLDINGS

B.11 A "minimum level of foreign tax" test, or one of the approaches explored in the preceding paragraphs, would restrict the range of companies from which dividends would be exempt. If the Government decided to introduce an exemption regime of this sort for dividends, consideration would need to be given as to whether such a restriction should be reflected in the exemption for gains on substantial shareholdings in foreign companies.

DIVIDENDS FROM CFCs

B.12 The CFC legislation prevents UK groups avoiding tax in this country by diverting income to subsidiaries in tax havens and in countries with preferential tax regimes. One of the main exclusions from the rules is where the CFC pays a dividend to its UK parent (the acceptable distribution policy or ADP exemption). The ADP works on the assumption that the dividend will be taxed in the UK. It would clearly be ineffective if dividends paid by CFCs were automatically exempted from tax. Dividends paid by a CFC in order to meet the ADP test for exclusion from the CFC regime would continue to be taxed in the UK. As now, a credit would be allowed for foreign tax attributable to such dividends.

IMPACT ON DIVIDEND POOLING

B.13 Dividends that were not exempted would continue to be subject to UK tax, with a credit for foreign tax. In the case of dividends that were exempted, neither they nor the foreign tax attributable to them would be able to be included in the onshore pooling regime introduced by Finance Act 2000. High levels of foreign tax on some dividends could not, therefore, be used to cover UK tax liability on other dividends with low levels of foreign tax if the latter were not exempted.

B.14 Again, it would be necessary to prevent such rules being circumvented by routing dividends into the UK through companies whose own dividends would qualify for exemption.

CONTROL THRESHOLD

B.15 If an exemption system were introduced, this would have to be consistent with the EU directive on parent companies and their subsidiaries. The control threshold for allowing

relief for underlying tax is 10 per cent of the voting power in the foreign company. The threshold for the EU directive is 25 per cent of the capital of the subsidiary.

B.16 Short of negotiating new bilateral treaties with each Member State, an exemption system would have to be based on the capital of the overseas company. Even assuming that the specified percentage was 10 per cent (which would be more generous than the 25 per cent threshold mentioned in the EU directive), the change of criterion from voting rights to capital might mean in principle that, in some cases, companies whose foreign dividends qualify now for relief for underlying tax would not qualify for exemption.

BRANCHES

B.17 It has already been suggested by some businesses that an exemption of some foreign dividends would have to be matched by an equivalent exemption for the profits of their overseas branches. Crafting an equivalent exemption for foreign branches of UK companies would add considerable complexity to the legislation required. It might also entail the need to create the equivalent of the CFC rules to cater for foreign branches on whose profits little or no overseas tax had been paid.

TAX TREATIES

B.18 Tax treaties have been negotiated, or are currently under negotiation, on the basis that the UK taxes dividends received by UK companies from their foreign associates and subsidiaries, subject to a credit for foreign tax. It is not possible to forecast how other countries would react to the introduction of an exemption system into the UK, even if it had the features (such as a “minimum level of foreign tax” test) described in paragraphs B.3 to B.6 above.

B.19 It is already the case that, in around a dozen tax treaties, reductions in other countries’ withholding taxes on dividends paid to the UK are given only if the dividends are subject to tax in the UK. Such reductions would not, therefore, be available in the case of dividends that were exempt from UK tax.

B.20 Article 16 of the current tax treaty between the UK and the US would allow the US to charge its full rate of withholding tax on dividends paid to a UK company if these were exempt from UK tax and 25 per cent or more of the capital of the UK company was owned, directly or indirectly, by one or more persons who were not individual residents of the UK and were not nationals of the US.

SUMMARY

B.21 The introduction of an exemption system for some foreign dividends (and, potentially, for some profits of foreign branches) would involve considerable upheaval for businesses affected by the change. A key issue in deciding whether this is a price worth paying is whether the change would lead to considerable simplification.

Views are invited on whether changing to an exemption system on the above lines would be of advantage to business.

C

ANNEX C: DEFERRAL RELIEF FOR GAINS ON SUBSTANTIAL SHAREHOLDINGS

C.1 The main features of the Government's proposals for a deferral relief from corporation tax on gains arising on disposals of substantial shareholdings were set out in the Inland Revenue's Budget Note 23 of 7 March 2001. They arose from two rounds of consultation with business on the basis of the Inland Revenue Technical Notes published in June and November 2000.

C.2 This annex restates those proposals a little more fully. It also highlights those detailed aspects on which agreement has not yet been reached on the most appropriate way forward and where further discussion is needed.

Comments are invited on these proposals, particularly the specific aspects highlighted below.

OUTLINE OF DEFERRAL RELIEF

C.3 As currently envisaged, the new relief would provide for chargeable gains to be deferred where:

- a qualifying shareholder company
- which has held a substantial shareholding in a qualifying investee company (a trading company or the holding company of a trading group) throughout a 12 month period
- realises a gain on the disposal of shares in that company, and reinvests the proceeds in:
 - shares in another qualifying investee company in which it has, or subsequently comes to hold, a substantial shareholding, and continues to hold a substantial shareholding throughout a 12 month period, or
 - assets that qualify for the capital gains business assets rollover relief.

C.4 The relief would also be available where a qualifying shareholder company disposes of qualifying business assets and reinvests in shares in a qualifying investee company:

- in which it has, or subsequently comes to hold, a substantial shareholding, and
- continues to hold a substantial shareholding throughout a 12 month period.

QUALIFYING SHAREHOLDER COMPANY

C.5 A qualifying shareholder company is a company which falls into one of the following categories:

- companies which are not close, whether or not trading
- close trading companies that are not members of a group
- close companies that are members of a trading group, whether or not the companies in question are themselves trading.

QUALIFYING INVESTEE COMPANY

C.6 The company whose shares are held must be a trading company or the holding company of a trading group.

DEFINITION OF 'TRADE', 'TRADING COMPANY' AND 'TRADING GROUP'

C.7 The meaning of 'trade' for the purpose of defining qualifying investee companies will exclude such activities which would, in most circumstances, be considered as trading activities but which are classified as 'investment business' under paragraph 9 of Schedule 25 ICTA. (The meaning of 'trade' for the purpose of defining qualifying shareholder companies that are close companies will not be restricted in this way.)

C.8 The definitions of 'trading company' and 'trading group' have been the subject of considerable discussion, with concerns being raised at adopting the definitions used for capital gains tax taper relief. As explained in paragraph A.6 of Annex A a particular point has been the distinction between the purpose-based definition of a trading company and the definition of a trading group, which focuses on the activities of group companies.

C.9 The way that the Inland Revenue applies these definitions for taper relief purposes has now been set out in an article in the June 2001 edition of *Tax Bulletin* (the relevant points are summarised in paragraph A.7 of Annex A).

C.10 The Government hopes that the guidance in the *Tax Bulletin* article will have allayed the earlier concerns about using the taper relief definitions for a deferral relief on substantial shareholdings. If the distinction between 'purpose' and 'activities' were still perceived as an issue for a deferral relief, the Government would be prepared to consider defining a trading company in terms of its 'activities' for the purposes of this relief.

Further comments are invited in the light of the guidance in the Tax Bulletin article on using the taper relief definitions for a deferral relief for substantial shareholdings. If there is still an issue, would it be preferable for the definition of a 'trading company' to be framed in terms of 'activities' for this purpose?

WHAT IS A SUBSTANTIAL SHAREHOLDING?

C.11 The proposals envisage that a substantial shareholding is defined as a beneficial entitlement to at least 20 per cent of the investee company's ordinary share capital, distributable profits, and distributable assets (as amplified by the rules in Schedule 18 ICTA 1988).

C.12 Where the qualifying shareholder company is a member of a trading group, it may be possible also to take into account other group members' beneficial interests in the qualifying investee company when determining whether the shareholding is a substantial shareholding. Aggregation of members' interests would be possible at any time when the shares could be transferred between them on a no gain/no loss basis under section 171 TCGA.

C.13 The Government proposes that deferral relief should also encompass part disposals out of a substantial shareholding as well as disposals of the entire shareholding. A disposal

of shares will qualify as long as a substantial shareholding in the qualifying investee company in question had been held throughout a 12 month period ending within the 12 months prior to the disposal.

C.14 Where a substantial shareholding is held, deferral relief will be available for acquisitions or disposals of shares in any class of shares in the company in question. But securities will not qualify, even if a substantial shareholding is held.

REINVESTMENT INTO ANOTHER SUBSTANTIAL SHAREHOLDING

C.15 In general, the conditions that determine whether the original disposal of shares can qualify for deferral relief will also apply in relation to a reinvestment in shares. Thus, for example, the new shareholding must be in a trading company or the holding company of a trading group. Similarly, providing a substantial shareholding (i.e. 20 per cent or more of the ordinary share capital etc) is already held, relief will be available for any class of shares acquired.

C.16 The Government proposes that deferral relief should cater for situations where the new substantial shareholding is built up in stages. Relief will extend to all acquisitions of shares in the qualifying investee company in the reinvestment period (i.e. 12 months before until 3 years after the relevant disposal) provided that:

- a substantial shareholding in that company is held at some time in that period; and
- the holding continues to be a substantial shareholding for at least 12 months.

C.17 Where further shares are acquired in the reinvestment period at a time when the holding is already a substantial shareholding, relief will be available for those shares only if the holding continues to be a substantial shareholding for at least 12 months after their acquisition.

C.18 Relief will be available for shares acquired by subscription, but there will be special rules within groups so that only the company realising the gain to be deferred can claim relief in respect of newly-issued shares.

ESTABLISHING A CLAIM TO RELIEF

C.19 Once the conditions for a claim to deferral relief have been established, relief obtained on acquisitions of shares will not be clawed back subsequently. A claim to relief can be established only after the qualifying conditions have been met. These are:

- the qualifying shareholder company must maintain the qualifying shareholding at or above the substantial threshold throughout the relevant 12 month period; and
- the qualifying investee company must, subject to paragraph C1.20 below, remain a trading company or a holding company of a trading group throughout that period.

C.20 However, relief will not be denied if the qualifying investee and shareholder companies have become members of the same group, and

- the trade of the qualifying investee company is transferred within the 12 month period to another company in that group; and
- the trade continues to be carried on within the group for the remainder of the period.

OTHER MATTERS

C.21 Special rules will facilitate the provision of relief where share reorganisations occur. Companies will be able to elect to disapply the normal ‘stand in shoes’ provisions so as to trigger a disposal on which deferral relief can be claimed.

C.22 Discussion continues with companies within the life insurance and North Sea oil sectors as to how the relief should apply to them.

C.23 As part of the package introducing a deferral relief for substantial shareholdings, the Government proposes that a gain arising under section 179 TCGA on a qualifying asset should be capable of being rolled over if another qualifying asset is acquired. Assets which qualify for CG business assets rollover relief and substantial shareholdings which qualify for the new deferral relief will be qualifying assets for this purpose, and the other conditions for rollover relief or, as the case may be, deferral relief will need to be satisfied. Relief for the section 179 gain may be claimed by the company chargeable under that section or, by virtue of the provisions in section 175 TCGA, by another company in the group of which that company was a member prior to the degrouping event.

Comments are invited on this new proposal.