ALIGNING TAX AND ACCOUNTING PROFITS
THE NEED TO REVIEW CURRENT LEGISLATION

Graeme Macdonald
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Tax Law Review Committee

THE INSTITUTE FOR FISCAL STUDIES
TLRC Discussion Paper No. 5

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DISCUSSION PAPER

by
GRAEME MACDONALD and DAVID MARTIN

for the Tax Law Review Committee of the Institute for Fiscal Studies

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CHAPTER 1

INTRODUCTION

The TLRC Discussion Paper no. 4, 'Tax and Accounting: A Response to the 2003 Consultation Document on Corporation Tax Reform' written by Graeme Macdonald and David Martin, supported a number of tax reforms for companies. These included the abolition of the schedular system, the abolition for most purposes of the distinction between income and capital, and the abolition of most distinctions between investment and trading companies. Another proposal was that section 42 FA 1998 should be generalised, so that all taxable profits of a company (not just Case I, Case II and Schedule A income) would be determined by reference to accounting profits, save where tax law provides otherwise.

It was suggested that in this way corporation tax could be rationalised and simplified, many unjustified economic distortions could be removed, and the scope for avoidance could be reduced.

It was therefore proposed that, in due course, a new Corporation Tax Act should be introduced, and that existing legislation should be reviewed to see whether it should be modified or perhaps omitted altogether in the light of closer alignment with accounts. The new Act would, of course, be drafted in accordance with the principles of the Tax Rewrite Project, but would not merely reproduce in redrafted style existing legislation unless the continued usefulness of that legislation had been established by the review.

A closer alignment with accounts would be the basic policy behind the new Act. This would provide coherence, which, not surprisingly due to its aggregation over a long period without an overall review, is lacking in the ramshackle state of existing tax legislation for companies. The opportunity should also be taken to consider the scope to rationalise the tax code for companies where the issues arising are not directly related to the tax and accounting aspect. Although there is much to be done, there should be sufficient time for a review to take place before the tax rewrite team wishes to commence its work on corporation tax having finalised the remaining income tax Bills. The rewrite process could even start on those matters that have been agreed while there are still some outstanding corporation tax issues to be considered.

Chapters 2 and 3 of this paper contain respectively a detailed consideration of the Schedule A legislation and the anti-avoidance rules for companies. A matter mentioned in the original Discussion Paper as suitable for review, although not directly related to the accounting issue, is the rules for group relief set out in schedule 18 ICTA 1988, and this is addressed in Chapter 4. The matters in these chapters were chosen for consideration in this paper as examples of areas worth reviewing, and because it was considered worthwhile to focus on some specific issues rather than simply to make general points about the need to rationalise and simplify corporation tax law.

It is submitted that these chapters, though limited to particular aspects of the taxation of companies, establish the case for generally reviewing the tax law applicable to companies rather than merely re-enacting it under the rewrite project, although it may be confirmed at an early stage that some areas do not need revisiting in detail. Such a review will also clarify how the various areas of tax law should fit together. In this connection, it is suggested that the Budget announcement that the government has concluded that capital allowances should be retained (although the system may be modernised) could be premature. This is because many related issues, such as the deductibility of capital expenses ('tax nothings'), apparently remain to be decided. A distinction needs to be made between what can be depreciated (which, in the absence of specific policy, would be expected to follow accounting) and the rate at which depreciation is measured (which might be determined or bounded by tax law). This is something that a later paper on the taxation of 'capital' assets will return to.

There are clearly limits to alignment with accounts, and, as discussed in the original Discussion Paper, the introduction of International Accounting Standards (IAS) demonstrates this point, but exceptions should be based on recognised principles and not merely made 'ad hoc'. The Revenue does indeed show an awareness of the need to keep in mind the tax principles that should direct policy – an example of this is the welcome analysis on the Inland Revenue website concerning factors that justify the departure of tax profits from accounting profits. What must be avoided, however, during the period of review, is the making of tax law without fully working out the implications in advance, rather like a train setting out from the station without knowing its final destination. It is hoped that this paper will not only establish the case for a review, but also assist in the process of deciding how corporation tax law should develop.

CHAPTER 2

THE APPLICATION OF STATUTORY SCHEDULE A PROVISIONS TO COMPANIES

PRELIMINARY

This chapter reviews the Schedule A provisions in part II of ICTA 1988 that were mentioned in Part I of Appendix B of the original Discussion Paper.

Reference is generally made to company taxpayers below, even though many of the points made are relevant to taxpayers generally.

Substantial steps have already been made towards alignment with accounts in relation to Schedule A profits, particularly by enacting in 1998 that Schedule A profits are computed (in the same way as trading profits) to be the same as accounting profits, subject to any contrary provision in tax law. This, together with the other accountancy-based provisions in FA 1997, removed many of the anomalies and avoidance possibilities previously derived from the fact that rentals were only normally taxable when due and payable.

The provisions of Schedule A that still lead to a difference between taxable and accounting income can generally be attributed to the tax law distinction between capital and income, and the avoidance opportunities that the distinction promotes. The distinction in tax law means that, in the absence of specific provisions, a capital transaction is *never* recognised in computing income, whether in the period of the transaction or subsequently (although capital gains taxation can bring it within the tax base). In particular, there has been a tendency for the courts to categorise the receipt of a number of years' income in a lump sum as capital rather than the income which, in economic terms, it substantively is. By contrast, the issue for accounting is one of *when* a transaction is recognised in computing income. The receipt of income in the form of a lump sum does not therefore preclude it from being recognised as income, though not exclusively in the period of receipt.

Thus it might realistically be anticipated that adopting an accounting solution as a basis for taxing lump sums would offer a workable alternative to many of the present Schedule A provisions. The accounts would recognise, for example, that a premium for a lease has a similar economic effect to a rental paid in advance, and treat both payments in a similar way. Nevertheless, particularly in the context of anti-avoidance, consideration must be given to whether the accounting solution is consistent with the central income concept and whether adopting that solution would make any significant difference to tax revenues. It must also be recognised that accounting is now concerned in the first place with the effect of the transaction on the statement of assets and liabilities (the balance sheet) and only consequentially with the resultant income. The accounting standards on finance leasing, for example, are primarily concerned to show the effect of a finance lease on the company's financial position; the division of the rental streams into depreciation as a cost of use and interest as a cost of finance is merely consequential on the prior decision as to the presentation of assets and liabilities.

The next section therefore considers in principle the issue of the taxation of lump sums, which in economic terms represent a number of years' income. In the light of this analysis and of accounting practice, the relevant sections in part II of ICTA 1988 are then analysed to see what differences they produce in taxable profit compared with accounting profit. In the light of the development in accounting standards referred to in the previous Discussion Paper, it is considered whether it would now be desirable to remove or to simplify those sections and to rely more on the accounting measure of profit for transactions within the scope of those sections.

THE TAXATION OF LUMP SUMS

Is there, in principle, any case for treating the receipt of a lump sum differently from other receipts, or, more pertinently, differently from the accounting treatment?

This question can be considered in the context of an issue considered recently by the courts[1] and legislated for by statute[2] – the sale of future rents for a present lump sum. Had the rents not been sold, tax revenues would have flowed from the annual receipts of the rents and tax relief would have been given on the payment of rents if they had been incurred as a business expense.

In calculating the lump sum for which the right to future rents would be exchanged, a discount rate would be used to establish the present value of those rents. Apart from representing the time value of money, that rate would also reflect any risk attributable to the future receipt of the rents. It would also reflect the minimum rate of return that the vendor could expect to earn on the lump sum; otherwise he would not exchange future receipts reduced by that rate for the lump sum.

In the accounts of the vendor, the lump sum would be allocated to the periods over which the rents would have arisen; it would not all be taken as income in the period of receipt. The basis of allocation, and the analysis of it within the accounts, might vary, but provided that no more than is recognised as income is distributed, the present value of the tax on the accounting income, discounted at the rate used in calculating the present value of the rents, will be the same regardless of how much of the lump sum is allocated to each period. This is because whatever is not allocated as income will be retained and earn at least the discount rate of return on reinvestment.

This analysis presupposes that the return on reinvestment, whatever the source – be it trading, rental or interest – is computed on an accounting basis. In other words, it is assumed that any schedular basis of taxation does not introduce differentials in taxation as between income from one source and another.

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[1] IRC v John Lewis Properties plc [2003] STC 117.
[2] Sections 43A–G ICTA 1988, introduced by FA 2000.

The conclusion of the court in this example was that the receipt of the lump sum was not income, no cognisance being taken of the accounting treatment. The statutory provision designed to counter this avoidance opportunity taxes the lump sum in the period of receipt.

Three points should be noted with regard to taxing lump sums on receipt even though they in fact represent a number of future years' income:

a. that if the lump sum is all 'upfront' income, such that it is distributed, this does represent a proper measure of tax liability;

b. that if the whole of the lump sum is not so regarded, then the return on reinvestment should be exempt from tax, and in so far as it is not, the initial taxation of the lump sum does not represent a proper measure of tax on income;

c. that whilst the tax revenue from the taxation of the lump sum will be certain, it will not, when discounted forward at a risk-free rate of interest, equate to the revenues that would have been received if the rents had been taxed on an annual basis when arising. This difference occurs because, on the annual basis of taxation, the tax revenues are in fact as risky as the rents themselves. Thus tax on a lump sum calculated by reference to a discount rate reflecting that risk can only generate annual equivalent tax revenues by discounting forward at the risk-inclusive discount rate, which would be the effect of not taxing the lump sum but of taxing the accounting measure of income including the return on reinvestment of that part of the lump sum not distributed as income.

A numerical example reflecting this analysis may usefully be considered, the detailed calculations underlying it being given in the Annex to this chapter. Consider the landlord of a property that anticipates receiving rents of £1,000 p.a. for the next three years at times t_1, t_2 and t_3. It decides (for whatever reason) to sell the right to these future rents for a lump sum of £2,486.85 received at t_0 and calculated as the present value of the future rents discounted back at 10% before tax. The assumed tax rate that the owner faces is 20%. If tax were paid immediately on receipt of the lump sum, it would amount to £497.37, this being the present value of the future tax receipts that would have arisen when discounted back at 10%. Consider three possible ways of accounting for this lump-sum receipt, assuming that the accounting income is tax-inclusive and that the tax and after-tax income are paid out at the end of each period:

A. accounting income is measured as the economic income, including interest, represented by the lump sum; that is, an amount equivalent to the annual rent;

B. accounting income is measured as one-third of the lump sum plus: in period 1, one-third of the interest; in period 2, one-third of period 1 interest and one-half of period 2 interest; and in period 3, interest as for period 2 plus interest for period 3;

C. accounting income is measured as one-third of the lump sum plus the interest on that part of the lump sum not yet accounted for as income (and so not distributed).

As is shown in the Annex, each of these approaches allows the income, including tax, to be withdrawn and leaves a nil cash balance. Each approach also gives a series of different tax flows, which all nevertheless have the same present value when discounted at 10% – that is, £497.37, the present value of the tax flows that would have arisen from the rentals in the absence of their sale in advance.

It is clear from the alternative shown in the Annex for A (economic income) that to tax the lump sum immediately regardless of the accounting measure of income can only result in a nil cash balance if the income from reinvestment (interest in the example) is untaxed. Only then will the present value of tax flows remain at £497.37. Even supposing this were desirable, it would only be possible to calculate the amount of income to be exempt if the discount rate were given or could be imputed. Whilst that would be possible in the case of the sale of rental in advance, it would be less likely to be feasible in the case of a lease premium.

It may be concluded, therefore, that in principle lump sums should not be taxed without regard to their accounting treatment.

The argument assumes that any distribution of income is limited to that accounted for as income. This assumption is consistent with the central income concept – that income is the amount that a company can distribute while remaining as well off as before. It is also consistent with company law, although it is recognised that an issue arises in connection with current proposals that the limitation of distributions under company law should be by reference to solvency rather than to income measurement. This is because it could then no longer be assumed that there would be a return from reinvestment on that part of the lump sum not accounted for as income, so that the present value of the tax receipts would not equate to that arising from the taxation of the annual rents. The issue would be whether this constituted tax avoidance or whether this should be regarded simply as a return of capital, which is what the proposed relaxation of the profits test in favour of the solvency test seeks to facilitate.

Should the issue be perceived as tax avoidance, then, in the context of closer alignment with accounts, a general tax provision might recognise accounting postponement of lump-sum receipts, or advancement of expenditure (provisions), only in so far as actual distributions (from whatever source) are within the resultant aggregate accounting income measure (including retained income). This would effectively amount to taxing the lump sum when it was in fact distributed, rather than when it was accounted for as income. The excess distribution, having been taxed, would give rise to a credit to be set against subsequent accounting income in order to avoid any double taxation.

Alternatively, if the distribution were considered simply a return of capital, the subsequent accounting measures of income would be taxed in the normal way. If the return of capital were reinvested in the corporate sector in an investment earning at least as high a return as the original, then the tax revenues would be restored to those that would have pertained had only the accounting incomes been distributed.

THE SCHEDULE A PROVISIONS

1. Section 30 ICTA 1988

History

This provision was introduced by section 37 ITA 1853.

Introduction

$^{1}/_{21}$ of capital expenditure on a sea wall is deductible against Schedule A profits in each year of assessment over a 21-year period.

Analysis

The relief applies to expenditure on a wall or embankment necessary to protect premises against flooding from the sea or a tidal river.

It is only available for Schedule A purposes, however (so that where potential relief would be significant, a trader is likely to consider having the land transferred and leased back to him by an associate who would be within Schedule A).

Curiously, 'years of assessment' are not construed as accounting periods for a claimant that is a company, but the deduction is apportioned to the accounting periods comprising the year of assessment.

Where the land is transferred to another person within the 21-year period, that other person thereafter becomes entitled to the allowance. The amount previously allowed to the transferor under section 30 would not then be deductible in its capital gains computation by virtue of section 39 TCGA 1992.

The accounts would depreciate the cost of the asset as appropriate.

Conclusion

This section provides for a form of capital allowance for sea walls, even though it is not included in CAA 2001. It was announced in the Budget that the government has decided to maintain the system of capital allowances, although it may be modernised. It may be that this section should be included in any such review of capital allowances. The purpose of providing an incentive for flood protection can be readily understood, particularly where third parties might also benefit, but it might be considered, for example, whether the relief should be restricted to Schedule A and whether defences against inland flooding should also enjoy relief.

2. Section 34 ICTA 1988

History

This section was introduced by FA 1963.

Introduction

A proportion of a premium paid for the grant of a short lease (i.e. not exceeding 50 years) is treated as rent for tax purposes. Only the balance of the premium is brought into account for capital gains purposes. The purpose of the section is essentially therefore to prevent the avoidance of tax by the payment of a premium rather than rent.

Where the tenant is placed under an obligation to improve the premises on the grant of a short lease, that obligation is deemed to give rise to a premium for these purposes.

Further, a sum paid in lieu of rent under the terms of the lease, or for the surrender of the lease or for waiver of any terms of the lease, is also treated as a premium for these purposes.

Analysis

The amount of the premium (P) taxed as rent equals $P-(P\times Y)/50$, where Y is the number of complete years (other than the first) of the lease. The rental element is all taxable in the accounting period in which the lease is granted (and not spread forward as an ordinary rental paid in advance would be for tax as well as accounting purposes).

The balance of the premium is subject to tax on capital gains in the accounting period in which there is an unconditional agreement for the grant of the lease (which could be earlier than that in which the lease is granted). The proportion of the base cost of the land that can deducted against this part of the premium is given by the usual $A/(A+B)$ formula, where A is the balance of the premium and B is the market value of the property that remains undisposed of (which is deemed to include the value of the right to the rental payments and the part of the premium deemed to be a rental payment).

If the landlord is granting a sublease out of a short lease, there are rules for abating the capital gains base cost for the intermediate landlord of its own lease (para. 1 and para. 4 schedule 8 TCGA 1992).

Although there is a legal distinction between a premium (which is a personal obligation on the tenant to pay the landlord) and rent (which is an obligation that ‘runs with the land’), the economic effects are similar. The accounts of a lessor would not distinguish therefore between rent in advance and a premium.

The accounting treatment of the grant of the lease depends on whether the lease is an operating lease or a finance lease.

If the lease is an operating lease, the payment of a premium or rent payable in advance is spread over the period to which the payment relates, normally on a straight-line basis so as to produce a constant return for the landlord.

If the lease is a finance lease, the lessor will be treated in his accounts as having disposed of the land. The gross earnings from the transaction will be the excess of the minimum lease payments and the unguaranteed residual value estimated to accrue to the lessor over the cost of the asset. The gross earnings are then allocated to accounting periods to give a constant periodic rate of return on the lessor's net cash investment. It should be noted that the 'capital elements' of the lease rentals, which reimburse the lessor for depreciation of the asset, are taxable even though not reflected in the accountancy earnings as they are written off against a receivable created in the balance sheet at the commencement of the lease. This means that a lessor who owns a building that is a depreciating asset as an investment will have taxable profits in excess of accounting profits, as there is no tax relief for depreciation if no capital allowances are available.

It is noted that if a lessor could be treated as owning the land as a trading asset for tax purposes, the lessor would then have taxable profits equal to accounting profits.

It does not appear that the section 34 rules are to be preferred to the accountancy rules for determining taxable profit. On the contrary, the accountancy rules seem simpler and more directly related to economic reality. If the building is a depreciating asset, the accounts will reflect depreciation whether the lease is an operating or a finance lease. It has been argued above that tax relief for depreciation would be an appropriate feature of a modern tax system, but even if this were not conferred, the accounting profit for the lessor could be adjusted for tax in the usual way by adding back depreciation without the need for the section 34 rules.

Taxation of a deemed premium where the tenant is obliged under the lease to improve the property can appear harsh. One can understand what motivates this provision – the possibility of avoiding tax by having the tenant pay money on improving the property rather than paying the money to the landlord or rather than the landlord improving the property out of taxed income. The property may, for example, be a depreciating asset. If the building cost £1 million and would be worth £800,000 at the end of the lease term but is worth £950,000 at the end of the lease term because of the tenant's improvements, it seems harsh to tax the landlord 'up front' on the present value of the £150,000. If the property is not depreciating, the landlord is nevertheless taxed on an unrealised profit – and indeed one could argue that the landlord is taxed on no profit at all in the event that no revaluation occurs in the books of the landlord. If at a future time the tenant were entitled to tax relief for the depreciation of his expenditure on improvements, the Revenue may well have a concern about symmetry if the landlord escaped any corresponding liability. This issue would need to be addressed further in the context of any proposals for tax relief for depreciation.

Sums paid in lieu of rent or for the surrender or waiver of any terms of the lease could also be taxed on an accounting basis rather than under the section 34 rules.

Conclusion

The accounting treatment is intended to determine the commercial profit, and is to be preferred to the somewhat arbitrary rules in section 34. It is suggested therefore that a premium for a lease should be taxed in the same way as an advance rental. Section 34 would then not be required.

The accounting rules should also be applied to determine whether a realisation of the original interest occurs, i.e. when the lease is a finance lease. Further, an investor in land who leases it under a finance lease should be taxed only on his accounting profit. There are two arguments for this. First, there is the general point that disallowing depreciation for tax purposes is a principle that cannot be defended in a modern tax system. A more specific argument can also be made in this case, although it has far-reaching consequences. This is that a person who buys land in order to let it on a finance lease has substantially given up his risk and reward in the asset – i.e. he might truly be regarded as trading in the land in any event, in a similar way to that had the asset been sold under hire purchase, so that full tax relief for the cost of the asset should be made available in these circumstances.

3. Section 35 ICTA 1988

History

This section was introduced by FA 1963.

Introduction

This section prevents the attempted avoidance of the charge under section 34 by granting a short lease to an associate at an undervalue and the associate selling the lease to a third party for what would otherwise be a capital sum. A proportion of the profit on the assignment of a short lease originally granted at an undervalue is treated as rent for tax purposes.

Analysis

The lesser of the amount forgone on the grant of the lease and the sales proceeds is treated as if it were a premium paid to the assignor of the lease. A proportion of the deemed premium, depending on the length of the lease sold, is taxed as rent received by the assignor.

It should be noted that the capital gains base cost for the assignor would be the market value of the interest acquired, assuming the acquisition was not by way of bargain at arm's length, unless the grantor of the lease and the subsequent assignor of the lease are two companies in the same capital gains group. In this case, the base cost for the assignor would be the appropriate proportion of the base cost of the grantor's interest, determined by reference to the market value of the lease that was granted and the market value of the whole interest.

This section would still be required, however, or the intra-group rules would need to be modified, if companies were generally liable to tax on their accountancy profits but intra-group transactions were deemed to take place for a consideration equal to the proportion of the original carrying value that corresponds to the proportion of the value transferred. To take an example, suppose a company has a freehold interest in land valued at £1,000, which has just been purchased for £1,000. It wishes to grant a 10-year lease to a third party for a premium of £400 and a nominal annual rent. If it did that, it would be liable to tax 'up front' on a deemed rent of $^{41}/_{50}$ of £400 under section 34 (= £328), and would not realise any capital gain, but the base cost of the freehold interest would be reduced to £928 (= £1,000–(£400–£328)). If the suggestion made above to tax premiums as advance rent were to be adopted, it would be liable to tax on £400 over the 10-year period and the base cost of the freehold would be £1,000.

Suppose instead that a lease was first granted within the group for no premium. The base cost to the group company lessee of the lease would be £400, and no gain would accrue to it if section 35 did not apply on the sale of the lease for £400. The carrying cost of the land for tax purposes in the parent company would be £600. Tax law therefore needs to address this problem, but it would appear that section 35 does not operate particularly well in this situation. This is because the lessee group company would have a deemed rent of £328 on the assignment to a third party, and a capital loss of £328. The lessor group company would have a base cost of £600 for the reversionary interest. This is not the same as if the lessor group company granted the lease directly to the third party.

If an accounts basis of tax were to be applied, the group rules would work satisfactorily if an intra-group lease were deemed to be granted for a premium equal to the appropriate proportion of the carrying value of the land for the lessor (of £400 in the above example) and taxed as such. There would be no tax cost to the group as long as group relief applied, but the right answer would be achieved if the lessee then sold the lease outside the group. In the example, the group lessor would continue to be liable to tax on the premium, which would be taxed over the 10-year period, and have a carrying cost of £1,000 for the land. The group lessee company would have no profit or loss, because the £400 would merely reimburse it for the premium deemed to be paid. The result would be just as if the lease had been granted directly to the third party.

(This treatment could also be applied more generally for a grant of a lease not on arm's-length terms – for example, by a parent company to an overseas subsidiary where tax law can leave unclear whether a deemed premium or deemed rent or both are to be imputed. The problems disappear if there is a deemed premium that is treated for the tax purposes as well as the accounting purposes of the payer and recipient in the same way as advance rental.)

Conclusion

Section 35 would not be required in an accounts-based system, although a new rule for intra-group leases would be appropriate.

4. Section 36 ICTA 1988

History

This section was introduced by FA 1963.

Introduction

When land is sold with a right to a reconveyance at a lower price, a proportion of the excess is taxed on the first seller 'up front' as rent. A similar result applies where there is the right to a leaseback instead of a right to a reconveyance, unless the leaseback occurs within one month of the date of the sale. The section is designed to catch arrangements that are essentially similar to leasing but that are designed to avoid the receipt of rent.

Analysis

If the time between the sale and repurchase is less than two years, all the excess is taxed as rent. If that time is two years or more, the amount of the excess taxed as rent is reduced by $^{1}/_{50}$ for each year other than the first between the sale and the repurchase date. The amount taxed as rent is taxable in the chargeable period in which the sale is treated as taking place. The consideration for the sale is reduced by the amount charged as rent for capital gains purposes.

Once again, it would appear that the accounting treatment could now supply the 'right answer' for tax purposes. FRS 5 applies to sale and repurchase agreements where the original seller has not relinquished the risks and rewards of ownership – in which case the arrangement is treated as a finance arrangement and (in this case) the seller will reflect a deemed interest receipt in its accounts and the original carrying value for the repurchased asset. Since the FRS 5 approach is acceptable for tax purposes for the sale and repurchase of securities ('repos'), it would seem that it should also be acceptable for the sale and repurchase of other assets, including land.

Conclusion

Section 36 would not be required in an accounts-based tax system.

5. Section 37 ICTA 1988

History

This section was introduced by FA 1963.

Introduction

Where there has been a charge to tax under section 34 or 35 on the grant of a lease or the assignment of an interest in land, there is some relief from a subsequent charge under section 34 or 35 on a subsequent grant of a lease or assignment.

Analysis

The relief applies where a charge to tax has arisen either under section 34 in respect of a premium paid on the grant of a headlease or under section 35 in respect of the assignment of the headlease, and a further lease is granted out of the headlease interest for a premium (such that section 34 may apply) or the headlease is sold (such that section 35 may apply). In this situation, the amount that would be taxed as rent on the second occasion is reduced by the appropriate fraction of the amount taxed as rent on the first occasion.

The appropriate fraction is defined for this purpose as A/B, where A is the duration of the lease used to calculate the charge on the second occasion and B is the duration of the lease used to calculate the charge on the first occasion.

Conclusion

This section would not be necessary if sections 34 and 35 ceased to apply.

6. Section 40 ICTA 1988

History

This section was introduced by FA 1964.

Introduction

This section provides for the apportionments to be made for Schedule A purposes of rents and other amounts pursuant to the contract between the seller and purchaser of an interest in land.

Analysis

An apportionment may be required where part of an amount is received or paid by a vendor after entering into the contract as trustee for the purchaser, or where part of an amount paid or received by the vendor before making the contract is attributable to the purchaser, or where part of an amount paid or received by the purchaser is attributable to the vendor.

The working of section 40 can be illustrated by an example. Suppose the vendor, V Ltd, owns land that is let for a rent of £4,800 p.a. payable by instalments of £1,200 in arrears on 1 March, 1 June, 1 September and 1 December. V Ltd has to pay water rates of £600 p.a. in instalments of £300 in advance on 1 April and 1 October. On 15 March 2001, a contract for sale is made with P Ltd, for completion on 30 April, and apportionments are made to that date. Accordingly, the purchase price is increased by £1,050 to reflect rent received by P on 1 June attributable to V Ltd (£800) and water rates paid by V Ltd on 1 April attributable to P (£250). V Ltd's accounting period ends on 31 March.

By virtue of section 40, P Ltd is treated as having paid the £250 water rates on 1 May (subsection (1)) and is treated as having received only £400 rent (£1200–£800 paid to V

Ltd) on 1 June (subsection (3)). V Ltd is treated as having received rent of £800 on 30 April (subsection (3)). The £250 refunded to V Ltd is treated as reimbursement of an amount said in subsection (1) to have been laid out by V Ltd as trustee for P Ltd.

Subsection (4A) provides, however, that amounts deemed under this section to have been received or paid are taken into account for Schedule A purposes in the period in which they are received or paid. This appears to create an anomaly in relation to the £800 deemed rental received by V Ltd because only £400 is attributable to its accounting period commencing 1 April 2001. It is not correct therefore to treat the entire £800 as taxable in that period. Even if it were correct, there is nothing that explicitly says that the accounting basis of tax does not apply for the preceding period so that the profits of the preceding period are correspondingly reduced. The same problem would also have arisen if, in the above example, the prepayment of water rates had been attributable in part to an accounting period of P Ltd commencing after the apportionment period.

Section 40 first applied when amounts were taxable or allowable under Schedule A in periods when they fell due. It would appear that the amendment in subsection (4A), which was intended to deal with the introduction of the new accounting-based rules for Schedule A, does not quite work properly in relation to apportionments that relate to different accounting periods.

Assuming that the law is not to be applied in this anomalous way, V Ltd is liable to tax on profits of £4,200 in its accounting period ended 31 March 2001 and on profits of £350 in its accounting period ended 31 March 2002. P Ltd is liable to tax on profits of £3,850 in its accounting period ended 31 March 2002. This is all exactly as one would expect from an ordinary accounts apportionment.

Conclusion

The section adds nothing to an accounts-based property tax, save to the extent that it creates potential anomalies, and can therefore be abolished.

7. Sections 43A–G ICTA 1988

History

These provisions were introduced by FA 2000.

Introduction

These sections provide that the proceeds of sale of rents, under arrangements that are treated as financing arrangements for accounting purposes, are in defined circumstances to be taxed as a Schedule A receipt. They negate the effect of the case of IRC v John Lewis Properties plc,[3] which was passing up through the courts when they were enacted. In that case, it was held that the sale of rents for a six-year period produced a capital

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[3] 75 TC 131.

receipt and not a Schedule A receipt for the vendor. The sections also ensure that a premium paid in certain circumstances for an interposed lease that is treated as a financing arrangement for accounting purposes is taxed as a Schedule A receipt (in which case section 34 does not also apply to the premium).

Analysis

Where a person transfers the right to receive rent in respect of land in the UK to another person under a finance agreement, the amount received for the transfer is treated as if it were the receipt of rent taxable in the accounting period of receipt. A finance agreement for these purposes is one in which, in accordance with GAAP, the company that receives the money under the transaction is obliged to reflect in its accounts a financial obligation (whether in respect of a lease creditor or otherwise). There is still a financing agreement for these purposes if the financial obligation only appears in the consolidated accounts of the company's group.

Similarly, where a finance agreement requires an amount to be paid as a premium for an interposed lease, the receipt of the premium is treated as a receipt of rent for tax purposes.

FRS 5 is the accounting standard which applies so as to treat the arrangement as being in substance a loan, and amounts equal to rentals sold are shown as receipts, which are applied in paying the principal and notional interest on the loan.

The sections do not apply if the term over which the financial obligation is to be reduced exceeds 15 years. This is because the Revenue takes the view that the arrangement then falls to be regarded as genuine investment in property rather than rent factoring (see Inspectors Manual (IM) para. 4773).

It is appropriate that a lessor should not be able to avoid tax on rentals simply by selling the rentals to a third party. If tax were to follow the existing FRS 5 approach, however, tax on the amount paid would be spread over the rental period to which it relates rather than all being taxed in the year of receipt, because tax would be due on the excess of the lease rentals over notional interest on the deemed loan, which equals in aggregate the amount paid for the rents.

It is noted that, if viewed as a financing transaction, the Revenue could apparently seek to apply section 786 ICTA 1988 to it. This section applies where a person assigns income from any property without a transfer of the property under a transaction effected with reference to the giving of credit. Where the section applies, it has the consequence that the transferor remains liable on the income assigned. This would be unjust in the present case because there would then be no allowance for a notional interest deduction on the amount 'lent'. It seems, however, that the Revenue does not seek to apply this section in this situation.

Conclusion

The accounting treatment of rent factoring ensures that the rents are in fact treated as income. Following the accounts for tax purposes would therefore similarly ensure that the lump sum is taxed, and the present anti-avoidance sections would therefore become redundant. This would also remove the artificial 15-year boundary, which does not seem particularly convincing as a way to separate ‘rent factoring’ from ‘genuine investment in property’, and produces a huge discrepancy between the tax treatment of two transactions close to the boundary but on different sides of it. The boundary also provides scope for avoidance. A landlord who wanted to grant a 20-year lease for a premium might, for example, consider avoiding section 34 by granting a lease at a rack rent and then selling the rental stream to a third party (who might be an associate of the tenant).

CONCLUSION

A summary of the conclusions in relation to the sections addressed above is set out below:

- Section 30 ICTA 1988 – should be retained, but perhaps revised.
- Section 34 ICTA 1988 – should be abolished in an accounts-based system.
- Section 35 ICTA 1988 – should be abolished in an accounts-based system (although a new rule for intra-group leases would be appropriate).
- Section 36 ICTA 1988 – should be abolished in an accounts-based system.
- Section 37 ICTA 1988 – would become redundant if sections 34 and 35 were abolished.
- Section 40 ICTA 1988 – should be abolished in an accounts-based system.
- Sections 43A–G ICTA 1988 – should be abolished in an accounts-based system.

The result of the above analysis is that most of the sections could be abolished in a corporation tax more closely aligned with the accounts. This is perhaps not surprising, since many of the sections were introduced to define what the taxable profit should be in circumstances where an accepted accounting treatment was missing and in circumstances where it was necessary to plug holes in other tax law to ensure that an appropriate level of tax was paid.

This conclusion can be tested by considering whether any of the factors that have been mentioned by the Inland Revenue (see www.inlandrevenue.gov.uk) as justifying a departure from accounting profit apply. It would appear that avoidance would not be a reason if profits have not been diverted and the company pays tax on its accounting profits. Of the other reasons mentioned by the Revenue for departing from accounting profits – public policy, transfer pricing, structural, tax neutrality, capital items, fiscal incentives, symmetry, volatility and ‘true reflection’ – ‘capital items’ would cease to be valid if capital and revenue distinctions are in general abolished for tax purposes and accounting principles are followed.

There remain consequential provisions, both in Schedule A and in the Taxes Acts more generally, which seek to introduce symmetry of tax treatment as between the payee and payer in the transactions involved, and related provisions in connection with the disposal of assets for the taxation of capital gains. It might be argued that in so far as there is scope within accounting for different allocations over time of lump sums as between lessors and lessees, there remains a requirement for symmetry, perhaps based on the accounting of the lessor, or perhaps by specific legislation. (It would be possible, for example, to preserve existing legislation that defines the length of a lease for tax purposes, so as to prevent the landlord and tenant recognising income or claiming expenditure over different periods by reason of having different views on this question.) Apart from this, there seem to be no factors justifying the departure from accounting profit.

Subject to further comments on the above analysis, it would seem that tax law in relation to Schedule A profits could be substantially simplified by aligning with accounts more closely. The somewhat arbitrary taxable amounts derived from the income/capital distinctions and the various formulae, together with the inevitable tax planning that is encouraged by such matters, would also be avoided.

ANNEX: LUMP-SUM RECEIPT OF THREE YEARS' RENT IN ADVANCE

Rent p.a. = £1,000
Present value (PV) = £2,486.85

Tax rate = 20%
Tax @ 20% = £497.37

Interest rate = 10%
Net of tax PV at t_0 = £1,989.48

A/c incomes	A Economic income	B $^1/_3$ lump sum + periodic interest	C $^1/_3$ lump sum + residual interest	A Economic income	B $^1/_3$ lump sum + periodic interest	C $^1/_3$ lump sum + residual interest	A Economic income Tax paid on lump sum at t_0 Interest taxed	Interest untaxed
	CASH FLOWS			TAX PAYMENTS			CASH FLOWS NET OF TAX	
Lump sum t_0	£2,486.85	£2,486.85	£2,486.85				£1,989.48	£1,989.48
Interest t_1	£248.69	£248.69	£248.69				£159.16	£198.95
Total cash t_1	£2,735.54	£2,735.54	£2,735.54				£2,148.64	£2,188.43
A/c income t_0–t_1								
incl. tax paid out	–£1,000.00	–£911.85	–£1,077.64	–£200.00	–£182.37	–£215.53	–£800.00	–£800.00
Net cash t_1	£1,735.54	£1,823.69	£1,657.90				£1,348.64	£1,388.43
Interest t_2	£173.55	£182.37	£165.79				£107.89	£138.84
Total cash t_2	£1,909.09	£2,006.06	£1,823.69				£1,456.53	£1,527.27
A/c income t_1–t_2								
incl. tax paid out	–£1,000.00	–£1,003.03	–£994.74	–£200.00	–£200.61	–£198.95	–£800.00	–£800.00
Net cash t_2	£909.09	£1,003.03	£828.95				£656.53	£727.27
Interest t_3	£90.91	£100.30	£82.90				£52.52	£72.73
Total cash t_3	£1,000.00	£1,103.33	£911.85				£709.05	£800.00
A/c income t_2–t_3								
incl. tax paid out	–£1,000.00	–£1,103.33	–£911.85	–£200.00	–£220.67	–£182.37	–£800.00	–£800.00
Net cash t_3	£0.00	£0.00	£0.00				–£90.95	£0.00
			Tax payment:	PRESENT VALUE t_0 OF TAX PAYMENTS			TAX PAID	
			t_1	–£181.82	–£165.79	–£195.93	–£39.79	
			t_2	–£165.29	–£165.79	–£164.42	–£30.95	
			t_3	–£150.26	–£165.79	–£137.02	–£20.21	
			Total	–£497.37	–£497.37	–£497.37	–£90.95	

CHAPTER 3

THE APPLICATION OF STATUTORY ANTI-AVOIDANCE PROVISIONS TO COMPANIES

PRELIMINARY

This chapter seeks to address the specific issue of tax avoidance by companies, and how this issue might be affected in company taxation by greater alignment with accounts. In particular, it seeks to determine whether existing anti-avoidance legislation could be rationalised or simplified in the light of such an approach. There is therefore a detailed discussion set out below concerning the effect of those anti-avoidance provisions in current tax legislation that were listed in Part IX of Appendix B of the earlier Discussion Paper.

This exercise seems particularly justified if a new Corporation Tax Act is to be introduced, because some anti-avoidance legislation may be found only to be appropriate in relation to non-company taxpayers and could be omitted from such an Act. Further, much anti-avoidance legislation was introduced at a time when other circumstances – not merely the development of accounting standards, but also other tax legislation current at the time – may have been very different from those at present. For example, anti-avoidance legislation introduced before capital gains tax, corporation tax or the imputation system, or before the abolition of repayable tax credits on dividends, may no longer be accurately focused having regard to the original mischief.

The principles of anti-avoidance legislation for companies

The accounts of a company, if properly prepared, provide a comprehensive reflection of all transactions that are undertaken by the company. In deciding what anti-avoidance provisions should be applied in the context of greater alignment with accounts, it is of course still necessary to consider in what circumstances a company might wish to reduce its accounting profit for tax reasons. In particular, it is necessary to examine the circumstances in which a profit that would otherwise accrue to the company is caused to accrue to a different entity which is more lightly taxed, although there may be some other situations in which a taxpayer wishes to achieve an objective different from the realisation of profit. Anti-avoidance legislation is likely to be required in these circumstances.

At present, much anti-avoidance legislation is also directed at preventing a company manipulating its affairs to exploit tax differences between the schedules, or between income and capital receipts or expenses, or between trading and investment activities etc., even though its aggregate accounting profits may be unaffected by such arrangements. This illustrates the general point, which is often made, that the more such provisions are introduced into tax law, the more there is the desire and also the scope for avoidance. The abolition of many of these distinctions would enable avoidance legislation to be considerably simplified. Nevertheless, some statutory tax adjustments to accounting profit will always be appropriate (such as, for example, the general exemption from corporation tax for UK dividends), and anti-avoidance rules will still need to catch artificial arrangements for exploiting such provisions. It is submitted, however, that the best place for such anti-avoidance rules (such as the bona-fide commercial requirement for rollover relief, or the precise conditions for enhanced relief for R&D expenditure or for relief for gifts to charities etc.) is normally within the provisions themselves, rather than in generalised anti-avoidance rules. In this way, they can be accurately targeted.

Of course, where two or more accounting treatments are available, tax law can, if desired, be introduced to prevent a company using the accounting treatment that minimises the profit for tax purposes. Such possibilities for tax legislation do not, one could argue, fall within the scope of an analysis of anti-avoidance legislation, and hence they are not discussed further in this paper.

In the analysis that follows, the discussion will therefore focus on identifying, first, those provisions needed to prevent a company manipulating its affairs so that profits that would otherwise accrue to it are taxed more lightly in the hands of some other person, and, second, those provisions needed to prevent a company manipulating its affairs so as to exploit tax differences created by other tax law.

A general anti-avoidance rule?

Finally, one might ask what requirement or scope there is for a general anti-avoidance provision, given closer alignment with accounts. It would seem that the best answer is that no such general provision is appropriate. The principal reason for this conclusion is that the company's accounts reflect all transactions undertaken by the company, and the resulting profit will be taxed accordingly in the absence of rules for statutory adjustment. A comprehensive set of rules for such matters as transfer pricing, close companies' dealings with shareholders, and controlled overseas companies is required but this should suffice to deal with the first form of manipulation of diverting profit. Such anti-avoidance provisions as are required to deal with the second form of manipulation should, as previously discussed, be contained within those other statutory rules, where they can be more clearly targeted and defined.

If, however, a general anti-avoidance provision is to be adopted, it is unlikely to operate successfully unless the underlying policy and purpose of the provision within the future framework of corporation tax are clear. To the extent that closer alignment with accounts is adopted as a policy, that framework may assist consideration of what it is that any general anti-avoidance rule is trying to achieve.

The analysis is provisional

The analysis that follows does not reflect what would be the undoubted benefit of discussion with the relevant Revenue specialists and consideration of precedents available to them. It may well therefore appear superficial in places, but if it stimulates consideration of the issues addressed, it will have achieved its primary object.

THE ANTI-AVOIDANCE SECTIONS

1. Sections 703–709 ICTA 1988

History

The principal part of these sections was first enacted in section 28 FA 1960 as a comprehensive response to combat 'dividend stripping' or 'bond washing' (i.e. broadly speaking, the avoidance of tax on income from securities), after earlier enactments had proved ineffective against schemes designed to circumvent them.

Introduction

The application of these rules by the Inland Revenue and the courts has not been restricted to dividend stripping, however, despite assurances to that effect given to the House of Commons at the time that the 1960 Finance Bill was under debate.[4] On the contrary, the provisions have often since that time been seen as a defence against a multiplicity of tax avoidance schemes which ingenious tax planners might otherwise be tempted to devise and to deploy. Indeed, in order that the provisions should be given the greatest possible application, it has been said that they should not be construed on the principle that the subject is not to be taxed except by the plain words of tax law, but that they should be interpreted widely to give effect to Parliament's intention.[5]

One could note in passing that, on the contrary, a case concerning (what is now) section 703 decided in favour of the Revenue before the decision in Pepper v Hart[6] might have been won by the taxpayer if recourse to the above *Hansard* statement had been allowed in order to resolve an ambiguity about whether the section applied in that case.

Nevertheless, the section is commonly viewed as a 'sweeping-up' provision, to be widely applied where necessary to deny a tax advantage from a transaction in securities, but only where it is not caught by other legislation.[7]

Given that companies are not, in general, liable to tax on dividends received, and given now that FA 1996 contains further anti-avoidance rules for loan relationships, it is to be expected that section 703 now has much less impact on companies than, for example, individuals and trusts.

[4] *Hansard*, 25 May 1960, column 508.
[5] IRC v Garvin [1981] STC 344 at 352. Greenberg v IRC 47 TC 240 at 271. IRC v Joiner [1975] STC 657 at 662.
[6] [1992] STC 898.
[7] IM para. 4521.

Analysis

Sections 703–709 apply where a taxpayer obtains a tax advantage as a result of a transaction in securities in one of the five circumstances set out in section 704, unless he can show (broadly speaking) that the transaction was entered into for a bona-fide commercial purpose without the intention of avoiding tax.

It will first be considered in general terms how section 703 might apply in order to prevent avoidance by companies in respect of dividend stripping, and then the possible function of section 703 as a ‘sweep-up’ provision for other avoidance schemes will be addressed.

Dividend stripping

The essence of dividend stripping is that arrangements are made to strip out the profits of a company without the shareholder paying the tax that would be due in the absence of those arrangements.

Dividend stripping (interpreted in a wide sense to include taking value out of a company otherwise than by dividends) might also be used in an attempt to obtain other tax advantages, such as generating tax losses.

Companies do not generally pay tax on UK dividends received. Therefore a company would normally save no tax if it made arrangements to avoid such a dividend receipt. Dealing companies require separate consideration, however.

Dividend stripping by dealing companies

A company that is a dealer in shares is liable to tax on dividends received in respect of the shares (following amendments to section 95 ICTA 1988 which took effect in 1996). It is therefore necessary to analyse whether section 703 is required to prevent the avoidance of tax on dividends by a dealing company.

Section 703 would not need to be applied in the event of a sale for full value, since the dealing company would bring into account the cum div. value of the shares for tax purposes. If the shares were to be sold for less than full value, transfer-pricing rules or the rule in Sharkey v Werner should apply.

If the shares were exchanged by a dealer for other shares or debentures as mentioned in section 473 ICTA 1988, so that a dividend could be paid on the original shares without being received by the original shareholder company, ‘rollover’ could be denied under the anti-avoidance provisions applied by that section.

Similar points would apply in relation to the avoidance by investment and dealing companies of tax on foreign dividends (for which no general exemption is available). It should be noted that the controlled foreign company legislation, which applies to prevent avoidance of tax by not paying out dividends from overseas subsidiaries, might also apply in this context.

'Dividends' include interest

'Dividends' are defined for the purpose of section 703 to include interest, and it should also be considered whether section 703 is required to prevent a company avoiding tax through a scheme involving the payment of interest that effectively strips the profit of a company.

It should be borne in mind, however, that there are other provisions that deny a deduction for interest where it is paid for tax avoidance reasons.[8] These other provisions would not apply if the company whose profits are being stripped were not UK resident. Nevertheless, a UK company could not strip the profits of an overseas company by disposing of loan stock in the company without paying tax, because accrued but unpaid interest on the loan stock will already have resulted in a tax liability (in contrast to dividends, which are only taxable when paid).

Other possibilities for saving tax if actual dividends are paid

Section 704B was designed to prevent a dealing company obtaining a tax deduction by buying shares and receiving a dividend and then realising a loss on the sale of the shares. The Revenue confirms that in view of subsequent legislation (including sections 731–734 ICTA 1988 considered below), this circumstance is 'virtually obsolete'.[9]

It may also be pertinent to decide whether section 703 is required to prevent a company that is not a dealing company from saving tax by receiving a dividend (tax-free) so as to mitigate the tax on a subsequent disposal of the shares for a consideration that would be reduced by virtue of the prior dividend. It is usually considered that section 703 does not apply, however, to schemes for reducing corporation tax on chargeable gains.[10] Further, section 734 ICTA 1988 (see below), sections 29–34 TCGA 1992 and section 177 TCGA 1992 contain relevant provisions to stop this.

It is not clear, therefore, in what circumstances section 703 is required to prevent tax avoidance by the company in relation to the payment of an actual dividend.

Other circumstances

Section 703 is not restricted to apply only where there are actual dividends, and (particularly by reason of circumstances C, D and E in section 704) can apply where a taxpayer receives value in a tax-advantageous manner which represents amounts available for distribution.

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[8] Para. 13 schedule 9 FA 1996 and section 787 ICTA 1988.
[9] See IM para. 4515.
[10] By reason of the definition of 'tax advantage' in section 709.

Since a company can normally receive such value tax-free by being paid an actual dividend, it is still not to be expected that section 703 should normally apply to a company.

The Annex to this chapter describes decided cases (which have indeed mainly related to individual taxpayers), with a view to identifying situations in which the section may catch companies.

There are no cases in the Annex in which a company has been held liable under section 703, and it would appear difficult to argue that a company should have been liable had it stood in the shoes of any of the individuals held to be liable in those decided cases. This is essentially because of the exemption afforded to investment companies for dividends and the fact that trading companies pay tax on their accounting profits (subject to contrary provision in tax law), and there are other tax rules that prevent trading companies from avoiding tax on the value of shares owned by them.

Is section 703 nevertheless required as a more general anti-avoidance provision, in order to address transactions in securities that go beyond the usual concepts of dividend-stripping schemes? Such schemes must, of course, still fall within one of the detailed circumstances set out in section 704 for section 703 to bite.

It is not possible to be exhaustive in describing what other transactions might be within the circumstances. One can look at examples, however. For instance, it might have been possible for a company to establish a subsidiary owning two classes of loan stock, one of which would go up in value on the subsequent determination of a defined exchange rate, and the other of which would then lose corresponding value. The impaired loan stock would then be transferred to a second subsidiary (for a consideration deemed for tax purposes to be equal to its original tax basis). The first subsidiary would then be sold to another group of companies which is able to shelter the tax profit to be realised on the valuable loan stock with its own tax losses, and the second subsidiary would be retained to use the tax losses to be realised in that subsidiary against the first group's own profits. Section 703 could have applied to prevent this scheme if the original parent company were a 'D' company as defined in section 704.

The avoidance in this example takes place because a company takes advantage of a section that enables it to transfer loan relationships on a no-gain no-loss basis within a group. In such a case, it would seem that the most appropriate anti-avoidance step is to limit the scope of the section that enabled the avoidance in the first place. In this example, the necessary amendments were introduced in FA 2003.[11]

For many years, it was very unusual for a company applying for advance clearance from section 703 to be refused, although it may be that more recently refusals have become more common. It would be interesting to see the statistics for the number of companies refused clearance, and to investigate the reasons for the refusal, and whether the mischief

[11] Para. 3 schedule 37 FA 2003.

identified by the Revenue in these cases could be more clearly addressed by specific provisions elsewhere in tax legislation.

Conclusion

Subject to further comments on the above analysis relating to dividend stripping, it is necessary to consider whether section 703 should be retained as a fallback, particularly for avoidance schemes that have not been specifically identified. Even if one accepts the requirement for general anti-avoidance rules, however, it is not clear why such a rule should then be limited to transactions in securities that occur only in the very detailed circumstances set out in section 704. Having regard to the complexity and detail of the provisions in these sections, it is suggested that they are not appropriate, even if it is considered that a general anti-avoidance rule may be required in relation to transactions in securities by companies. Such a rule should be based on whatever principle is perceived to be at stake in relation to transactions in securities by companies. This principle would need to take into account that investment companies do not pay tax on UK dividends, trading companies are still taxed on their trading profit if they attempt to avoid receipt of UK dividends, the controlled foreign company legislation exists to prevent the avoidance of tax by not receiving foreign dividends, and the loan relationship legislation now provides a comprehensive code for the taxation of interest-bearing securities.

2. Section 730 ICTA 1988

History

This provision was first enacted as section 24 FA 1938.

Introduction

Where a person owning securities sells or transfers a right to receive ‘interest’ (defined to include dividends and annuities) payable in respect of the securities, without selling or transferring the securities, the interest is deemed to continue to be his income for tax purposes, and is not deemed the income of any other person. The income is deemed to arise to the seller or transferor in the chargeable period in which the sale or transfer takes place.

This section was first introduced as a response to the case of Paget v IRC.[12] In that case, the holder of bearer bonds sold the coupons and it was held that the purchase price of the bonds was not income arising from the bonds but the purchase price of the income. The taxpayer escaped all liability to tax on the sale as a result of that decision, because, in particular, capital gains tax had not yet been introduced and the individual was not a dealer in the coupons.

[12] 21 TC 677.

Analysis

The section does not now apply to interest payable under loan relationships.

Where section 18(3B) ICTA 1988 applies so as to tax the proceeds of sales of coupons for foreign dividends effected by a UK bank, or by a person who is not a dealer in such coupons to a UK dealer, the amount of interest deemed to belong to the owner equals the amount of the sale proceeds.

It should be noted that the section merely states that the income is not deemed to belong to anyone other than the original seller, rather than saying that the income is deemed not to belong to any other person. As the income actually belongs to the purchaser, the purchaser could therefore in theory still be assessed, although the Revenue does not take this point in practice.

It is not clear what this section achieves in relation to a company.

If the company is not a dealer and sells the right to UK dividends, the section does not apply so as to increase the company's tax liabilities (because it is deemed to receive dividends that are tax-free).

The proceeds of sale of overseas dividends are either caught by section 18(3B) ICTA 1988 or (if that section does not apply because the sale is not to a UK dealer) subject to tax as a capital sum derived from an asset.

If the company is a dealer, the section makes no difference (assuming that double taxation on the actual proceeds of sale and on the deemed dividend receipts does not occur).

As mentioned, the section does not apply to interest on loan relationships.

The section would appear to have only a limited application in relation to annuities, since the nature of an annuity is normally an income stream, and the sale of the income stream is therefore a sale of the entire rights under the annuity. An exception might be where the annuity reserved a right to a lump-sum payment in the event of, for example, the death of the annuitant, and that right was not assigned. In the very limited circumstances in which a company might retain rights after the sale of the income stream, it would, however, appear that section 786(5) ICTA 1988 may apply.

The relationship between section 786 (which applies to transactions effected with reference to lending or the provision of credit, including annuity transactions) and section 730 is unclear. For example, where section 786 is applied, the buyer can (in contrast to the Revenue interpretation of section 730) also be made liable to tax on the income.

Further, since section 730 has not been adapted to reflect the introduction of capital gains taxation, it leaves unclear whether a seller is nevertheless taxed on the actual sale proceeds as a capital sum derived from an asset. It might be reasonable for a corporate investor in the shares to be so liable on a sale of the right to dividends, but an individual investor would be liable to double taxation in a similar situation.

A company dealing in the shares would also be liable to double taxation if both the sales proceeds and the dividends were taxed.

It is also relevant to note that a company can, in any event, usually readily avoid the section by first transferring the securities, without the right to income from them, to an associated company and then subsequently selling or transferring the right to the income. Section 730 does not appear to apply in this situation. Further, the section might actually enable avoidance to take place, in circumstances where income is deemed to belong to a lower-rate taxpayer (or non-resident) although it actually accrues to a higher-rate taxpayer.

Conclusion

It is not clear in what circumstances the section is necessary to protect the Revenue in relation to securities held by a company, for the reasons mentioned above. It is submitted that it should be abolished for companies.

3. Section 730A ICTA 1988

History

This provision was introduced by FA 1995.

Introduction

This section sets out rules for the treatment of the tax differential on the sale and repurchase of securities. The broad effect is that where a person sells securities and, as a consequence of an obligation or option entered into in pursuance of the same arrangement, he or a connected party subsequently repurchases those securities, the difference between the sale price and the repurchase price is treated as a payment of interest on a deemed loan.

Analysis

Where section 730A applies, the difference between the sale price and the repurchase price is treated as a payment of interest for tax purposes. To avoid double counting, the repurchase price is deemed to be reduced by the amount of such deemed interest paid by the interim holder, or increased by such amount if the deemed interest is paid by the original owner. This adjustment is inappropriate and is not made, however, where section 263A TCGA 1992 applies such that the sale and repurchase are ignored for capital gains purposes.

The deemed interest is taxed for companies in accordance with the loan relationship legislation in FA 1996 on the basis that an authorised accruals basis of accounting applies to the interest.

Section 730A does not apply, however, if (subject to regulations) the sale and repurchase are not on arm's-length terms, or if *all* of the benefits and rewards arising from fluctuations in value of the securities accrue to the interim holder. It is for this reason that the section may be classed an 'anti-avoidance' provision.

Section 263A TCGA 1992 provides that a sale and repurchase agreement does not give rise to a disposal for capital gains purposes on condition that *none* of the risks and rewards associated with the asset passes to the interim holder, and that the transaction is on arm's-length terms. Where section 263A does not apply, the repurchase consideration is reduced for capital gains purposes by the amount of deemed interest to prevent double counting.

The Revenue states that the difference between section 730A and section 263A concerning the passing of risk is deliberate, to try to ensure that the rules are not exploited for avoidance purposes.[13]

There will be no derecognition of the asset in the accounts of the seller under FRS 5 if there is no significant change in the company's ownership of risks and rewards in connection with the asset. The ostensible sales proceeds are recorded as a loan, and any charges that are in substance interest will be shown as such in the accounts.

No specific tax legislation is therefore required for a dealer in securities, since the tax profits of a trade are computed in accordance with the accounting profit unless there is a rule of law that determines otherwise.

It would nevertheless appear that section 730A is defectively drafted because if, for example, the sale is not at arm's length, the accounts may still not reflect the recognition of any gain. Saying that section 730A does not apply does not displace the basic rule that a trader's tax profit for Case I equates to his accounting profit, and is not therefore sufficient to introduce the tax rule that is then intended to apply.

Conclusion

There are confusing differences between section 730A, section 263A TCGA 1992 and the accounting requirements relating to the passing of risk. The tax rules differ from the accounting rules where, for example, on the sale of a capital asset there is a small, but not for accounting purposes a significant, passing of risk to the purchaser.

If capital and income distinctions are, in general, abolished for tax purposes, this distinction would disappear, but perhaps the tax law could in any event be amended to match the accounting approach where there is some passing of risk but the passing of risk is not significant.

The only anti-avoidance rule then required would be if the transaction were not at arm's length. A suitable rule may already exist if the payer of the deemed interest is a UK resident company, because the unallowable purpose rule of para. 13 schedule 9 FA 1996

[13] See IM para. 4318.

will apply to deny tax relief for the interest where tax avoidance is present. This rule would not suffice for other cases, however, and it may be simpler merely to provide that a disposal is recognised for tax purposes where the transaction is not at arm's length and tax would be saved if there were no such recognition.

It would appear therefore that section 730A (together with section 263A) could be substantially simplified, particularly if income and capital gains distinctions are abolished for the tax purposes of companies.

4. Sections 731–734 ICTA 1988

History

These provisions were introduced by FA 1959 to fill gaps in earlier 1937 legislation.

Introduction

These sections apply to counter avoidance possibilities for the buyer of dividends. One example arose before the modification of section 95 ICTA 1988, which charged to tax dividends received by companies that are dealers in securities. A dealer could then buy shares cum div., receive the dividend tax-free, and immediately sell the shares so as to realise an overall trading loss that could be set for tax purposes against profits on other transactions. Following the amendment to section 95, however, this possibility for tax avoidance no longer exists.

Counteraction is still appropriate, however, in relation to certain transactions in overseas securities by dealers, and in relation to dividend buying by companies that are not dealers.

Analysis

The definition of 'securities' for the purpose of these sections excludes debt-bearing securities, and the provisions apply in practice therefore only to UK and overseas equities.

The sections apply if the purchase and the taking of steps to sell occur within a six-month period if there is an agreement or arrangements for the sale at the time of purchase, or within a one-month period otherwise.

A company that is a dealer in securities could generate a tax benefit in respect of overseas dividends by claiming tax credit relief for overseas tax withheld and a Case I loss on the purchase and sale of the shares. Section 732 is directed at this issue, and an appropriate proportion of the dividend or interest is deducted for tax purposes from the acquisition cost of the securities. Section 732 does not apply, however, if credit is not claimed for the foreign tax against UK tax but the foreign tax is merely deducted in the UK computation of profit.

Section 734(2) counters dividend buying by companies that are not dealers in securities, whether in relation to UK or overseas shares. It does this by providing that, for all purposes except capital gains, an appropriate proportion of the gross dividend is disregarded (as is any foreign tax on that amount). An appropriate proportion of the net dividend is, however, treated as a capital distribution within section 122(5)(b) TCGA 1992.

Conclusion

Some difficult theoretical issues apply on the taxation of dividends received by companies. If, for example, a general exemption from tax is appropriate for UK dividends to avoid double taxation of profits within the corporate sector, it is not obvious that the exemption should not apply to trading companies. Nevertheless, removing the exemption is consistent with the general concept that trading companies should pay tax on their trading profits. If the capital/income distinction is in general abolished for companies, it may therefore be necessary specifically to maintain the distinction on taxing dividend income of trading and investment companies (subject also to any further review of this issue necessary to ensure compliance with EU law).

Subject to such general considerations, it would appear that these anti-avoidance provisions remain appropriate, though their scope is more limited following the change to section 95 ICTA 1988.

5. Section 736 ICTA 1988

History

This section was introduced by FA 1969.

Introduction

Where a dealing company owns a holding of at least 10% of a class of securities issued by a UK resident company, and the value of that holding is materially reduced by one or more distributions, the reduction in value is added to the carrying value of the holding, and to the proceeds of sale, in order to determine the tax liability of the dealing company.

Analysis

This section now results in double taxation for dealers, and the Revenue confirms that section 736 is not to be applied where section 95 ICTA 1988 taxes the distribution in the hands of the dealer.[14] It is confirmed that this section is only likely to be used in relation to insurance companies, which are excluded from section 95.

[14] See IM para. 4431.

Conclusion

Section 736 should be abolished in its general form, because it is not satisfactory that a mandatory section is not applied in practice on the basis that it is inappropriate. Any special rules required for insurance companies should be introduced for insurance companies only.

6. Sections 736A, 736B, 737A and schedule 23A ICTA 1988 and section 97 FA 1996

History

Sections 736A, 736B, 737A and schedule 23A were introduced by FA 1991, FA 1997, FA 1994 and FA 1991 respectively.

Introduction

Under these complex provisions, manufactured dividends are treated in a similar way to actual dividends for tax purposes. If they are paid or received by a dealer, they will be taken into account in his Case I computation (without any adjustment relating to tax credits). Manufactured dividends are not taken into account for shadow ACT purposes.

The corporation tax treatment of manufactured interest is based on the loan relationship legislation, with trading and non-trading debits and credits arising for the payer and recipient of the manufactured interest. A UK person who pays manufactured interest is commonly required to withhold 20% of the gross amount. There is, however, no need to withhold tax on manufactured interest that represents interest on gilts or other securities which is payable without withholding.

Where there is no requirement on the interim holder to account for manufactured dividends or interest to the original owner, but it is reasonable to assume that dividends or interest to be received by the interim holder have been taken into account by them in determining the repurchase price, section 737A applies. This section deems manufactured payments to be made, so as to put the parties in a similar tax position to that if manufactured payments had actually been made.

Analysis

The rules are not primarily to be regarded as anti-avoidance rules but provide for the necessary mechanics for taxation in the wide variety of circumstances that are possible. They need to address, for example, payments to or by UK or overseas companies, individuals or other entities in relation to UK and overseas securities, and such other matters as irregular manufactured payments. To some limited extent – for example, the rules for deemed manufactured payments, or the rules where irregular manufactured payments do not match exactly the amounts received by the interim holder for tax avoidance reasons – the provisions can, however, be regarded as anti-avoidance measures.

Where the purchaser is required to account for interest or dividends received on the securities by the original seller (or third party), the deemed interest payment created by section 730A is adjusted to reflect the amount of the manufactured interest or dividend. A deemed manufactured payment results in a similar adjustment.

If the purchaser is entitled to retain income on the securities, the commercial effect is that this represents interest on its loan, but the seller has the possibility in its accounts either to gross up its profit and loss account to show income from the shares and an interest expense, or simply to show the excess of interest due over the dividends actually paid. FRS 5 permits either treatment. In this way, it is possible that the accounting and tax treatments may differ (depending on the accounting treatment adopted), but it would not appear that the net taxable profit is affected.

Conclusion

A detailed analysis of the provisions is not attempted, since they are not primarily to be regarded as anti-avoidance provisions, although they are mainly to be found in part XVII of ICTA 1988 which is headed 'Tax Avoidance'. It is noted that schedule 24 FA 2004 introduced further anti-avoidance provisions in relation to manufactured dividends, but these provisions are not addressed in this paper. It can, however, be noted in passing that some simplification of the provisions would be possible in a new Corporation Tax Act, because many of the detailed provisions do not apply to companies and would therefore be omitted.

7. Sections 747–756 ICTA 1988

History

These provisions were introduced by FA 1984.

Introduction

These sections (and the related schedules) contain the controlled foreign company rules whereby, broadly speaking, the chargeable profits of subsidiaries that are resident in low-tax jurisdictions may be imputed to a UK resident parent company.

Analysis

A detailed analysis is not given in this paper, as the rules are justified on the principle of preventing the diversion of profits to lower-taxed entities – see earlier in this chapter.

Conclusion

No substantive changes to these provisions may be appropriate.

8. Sections 757–764 ICTA 1988

History

These provisions were introduced by FA 1984.

Introduction

These sections contain the rules for treating the gain realised on the disposal of a material interest in a non-qualifying offshore fund as an income gain rather than a capital gain.

Analysis

A person has a material interest in an offshore fund for these purposes if he has an interest in a non-resident company, unit trust or other similar overseas entity and it can reasonably be expected that at the time of acquiring his interest he could realise the value of the interest within seven years. The person 'realises the value' if he can realise an amount that is reasonably approximate to the portion that the interest represents in the underlying investments of the company or trust.

Exemption is available from these rules where the Board of Inland Revenue certifies the fund as a distributing fund on the basis, broadly speaking, that it distributes at least 85% of its income.

No indexation allowance is available to a company realising a gain that is treated as income rather than a capital gain under these provisions.

Conclusion

This legislation currently has a limited impact on companies, and this would be even more true if (as is suggested in the earlier Discussion Paper) income and capital distinctions are abolished and the indexation allowance is withdrawn. There would then be no sufficient reason to retain these rules in a new Corporation Tax Act.

9. Sections 768, 768A, 768B, 768C, 768D and 768E ICTA 1988

History

Sections 768, 768A, 768B, 768C, 768D and 768E were introduced by FA 1954 (as amended by FA 1969), FA 1991, FA 1995, FA 1995, FA 1998 and FA 2002 respectively.

Introduction

These sections set out the rules for denying the carry-forward of tax losses by a company after the change of ownership of the company where (in accordance with the particular rules for each kind of company) the acquisition of the tax losses would otherwise be regarded as constituting avoidance.

Analysis

Section 768 provides that trading losses cease to be available for carry-forward following a change of ownership where there is a major change in the trade or where the activities of the trade become negligible within three years before or after that change of ownership. Under section 768A, trading losses in similar circumstances arising after the change of ownership cannot be carried back against profits arising before the change of ownership.

Under section 768B, losses of an investment company (whether excess expenses of management or charges on income) cease to be available for carry-forward following a change of ownership where there is a significant increase in the capital of the company, or a major change in the business of the company, or the activities of the company become negligible within three years of the change in ownership. Following a change of ownership of an investment company, where losses are not prevented from being carried forward under section 768B, section 768C applies so as to apportion the losses which may be used to set against a gain accruing on the disposal by the investment company within three years of the change of ownership of a capital asset that was acquired from another company in the group after the change of ownership.

Section 768D contains similar restrictions for a company that has Schedule A losses from using those losses to set against profits after a change in ownership. Section 768E contains similar restrictions for a company that has a non-trading loss on intangible fixed assets from using such a loss to set against profits arising after the change of ownership.

Conclusion

If the schedular system is abolished, the above rules could be significantly simplified so as to provide, for example, that losses cannot be carried forward after a change of ownership if there is a major change in the business of the company within three years of the change of ownership or if within three years the activities of the business become negligible.

10. Section 770A and schedule 28AA ICTA 1988

History

These provisions were introduced by FA 1998.

Introduction

This section and schedule 28AA (as prospectively modified by the Finance Bill 2004) contain the transfer-pricing rules whereby, broadly speaking, an arm's-length price may be substituted for the price actually paid on a transaction between related companies.

Analysis

A detailed analysis is not required for the purposes of this paper, as the rules are justified on the principle of preventing the diversion of profits to lower-taxed entities – see earlier in this chapter – or by European tax considerations.

Conclusion

The provisions should be retained.

11. Section 774 ICTA 1988

History

This section was introduced by FA 1960.

Introduction

Where a dealing company obtains a tax deduction for the depreciation in the value of a right subsisting against an associated company (being a non-dealing company), or for a payment made to that associated company, but the non-dealing company is not otherwise liable to tax, the non-dealing company is deemed to have a taxable receipt equal to the amount deducted by the dealing company.

Analysis

This section would operate, for example, where a dealing company lends money to a non-dealing company, and interest rates then rise and the value of the security falls. The dealing company could then realise a loss by selling the loan to an associate (although not to a fellow group company). The section would deny the loss for tax purposes.

Conclusion

The concept behind this provision is reasonable, but its detailed drafting could perhaps be reviewed so as to extend its scope. For example, a similar commercial result would have been obtained if, in the above example, the initial loan had been to a company that is also a dealing company. The section would not then apply, however, to deny the tax advantage.

12. Section 776 ICTA 1988

History

The section was introduced by FA 1969.

Introduction

The principal purpose of the section is to provide that certain gains of a capital nature obtained from the disposal of land are to be treated as income rather than capital. The section was not listed in Part IX of Appendix B of the earlier Discussion Paper because this does not affect the amount of profit that is taxed but only the way in which it is taxed. The section should perhaps have been mentioned, however, because it has the significant secondary purpose of preventing the diversion of profits from land to a lower-taxed entity.

Analysis

The section applies where land is acquired with the object of realising a gain on its disposal, or where land is held as trading stock or land is developed with the object of realising a gain from the disposal of the developed land, and a gain of a capital nature is obtained from a disposal of the land or property deriving its value from the land.

The provisions of the section are widely drawn and can be confusing. One commentator at the time it was introduced (D.C. Potter) said, 'The section seems, in part, designed to terrorise by its obscurity'. Similar sentiments were expressed by Buckley LJ:

> [Section 776] is, like so many sections in the Taxing Acts, one the length and obscurity of which tends to obscure its purpose and effect. Notwithstanding that subs (1) affords a clear indication of the purpose which the section is designed to serve, viz. to prevent the avoidance of tax by persons concerned with land or the development of land, I confess that I first travelled through the section finding very little light on my journey to aid my understanding of it.[15]

The section can, it is accepted by the Revenue, apply to commercially motivated transactions, although an advance clearance procedure is available (save in situations where land is held as trading stock) to obtain confirmation that the section does not apply to a proposed disposal.

Most of the problems associated with the section are not, however, examined in this paper, since, to the extent that the section provides for capital gains to be taxed as income, it would have no effect if capital/income distinctions were in general abolished.

The section also applies, however, to a 'diversion scheme' whereby a person who 'directly or indirectly transmits the opportunity of making a gain to another person' (for example, a non-resident subsidiary) can be assessed. The assessed person may then have a statutory right to recover the tax from the person who actually realises the gain. The drafting of this provision should be improved, because the expression 'transmits the opportunity' is too vague, and the section should apply only to counter tax avoidance. Otherwise, the underlying concept appears to have continuing relevance.

[15] Yuill v Wilson 52 TC 674 at 693.

Conclusion

This section would, to the extent that it deems a capital gain to be an income gain, no longer be required for companies if income and capital distinctions were abolished for companies. That part of the section that tackles ‘diversion schemes’ would still be required, however, where tax avoidance would otherwise occur.

13. Section 779 ICTA 1988

History

This section was introduced by FA 1964.

Introduction

Tax relief for rent following a sale and leaseback of land is not to exceed the commercial rent for the land.

Analysis

The section could have applied if, for example, a trader granted a long lease to a property company at a nominal rent but for a large premium, and was then granted back a lease at an excessive rent in the early years, followed by a nominal rent in the later years. The trader would not now, however, be able to charge his accounts under GAAP for the excessive rent in the early years in any event, so that no tax deduction for this would be available irrespective of section 779. The case of Gallagher v Jones[16] confirms this. Where the leaseback is a finance lease, SP3/91 sets out how SSAP 21 is applied for tax purposes, and where the leaseback is an operating lease, SSAP 21 specifically requires the rents to be averaged, unless special circumstances apply, such as rents being contingent on usage. To this extent, the section, together with the other sections that follow, appear to have been superseded by developments in accounting practice.

It is also possible, however, that the rent would be excessive because the original sale price exceeds market value. In this case, the original sales price would normally give rise to a taxable profit, but the section could perhaps be retained to cover the more limited situation where land is sold for an excessive price, but not for a taxable gain. This could occur where the land has fallen in value and the land could still be leased back on a commercial basis at a rent that exceeds the market rent at the time. It should be noted that if the rent were excessive only because the parties are connected, and not because the sale price exceeded market value, the transfer-pricing rules should apply, and so section 779 should not be required in this situation.

Conclusion

The section is not required in its current form in an accounts-based tax system that applies generally to taxpayers (and not just to taxpayers to whom section 42 FA 1998

[16] 66 TC 77.

applies). It may, however, be required in more limited form where the land is sold for a price that exceeds market value but (by reason of a high acquisition cost) the sale is not taxable.

14. Section 780 ICTA 1988

History

This section was introduced by FA 1972.

Introduction

Where a lessee receives a capital sum on the surrender or assignment of a long lease and then takes a new lease for a period not exceeding 15 years, a part of the capital sum (determined by a formula) is taxed as income of the lessee.

Analysis

The potential application of the section is perhaps best illustrated by an example. Suppose a taxpayer occupies offices under a lease with eight years to run at a rent of £30,000 p.a. and assigns the lease to a pension fund for £200,000. An immediate leaseback is granted for a period of eight years less one day for a rent of £70,000 p.a. The commercial rent is £100,000. Since the rent does not exceed a commercial rent, no adjustment is possible under section 779. The income proportion of $^{8}/_{15}$ of £200,000 (£106,666) is, however, taxed under section 780 as income, and the balance (£93,334) is liable to tax as a capital gain.

Conclusion

Although the section has a clearer application at present than section 779, it would not be required in an accounts-based system of corporation tax that did not recognise distinctions between capital and income receipts, and which would produce a less arbitrary result.

15. Section 781 ICTA 1988 (as extended by section 783 ICTA 1988)

History

This section was introduced by FA 1964.

Introduction

Where a tax deduction is granted to a person for a payment under a lease of an asset (of any description other than land), and that person subsequently obtains a capital sum in respect of the lessee's interest in the lease, that person receiving the capital sum is charged to tax on an amount equal to that for which the tax deduction was allowed.

Analysis

Again, an example perhaps best illustrates the potential application of the section. Suppose a taxpayer takes a lease of plant at a rent that is set at £5,000 p.a. for four years and subsequently at £1 p.a. After year 2, the trader sells the lease for £12,000. A Case I assessment would then be made of £10,000 under section 781 if the taxpayer had obtained tax relief for the full £5,000 in each of years 1 and 2. This deduction would be denied in any event to a trader, however, since GAAP would only permit charging an appropriate proportion of the rent in the early years to the accounts. The sales proceeds would then, to a large extent, merely represent the reimbursement of rent that had been prepaid.

Conclusion

The section is not now apparently relevant to taxpayers within Case I or Case II of Schedule D or Schedule A, by reason of section 42 FA 1998. On this analysis, it would no longer be required in an accounts-based system of tax that applied to taxpayers generally.

16. Section 782 ICTA 1988

History

This section was introduced by FA 1964.

Introduction

Where a trader uses an asset (of any description other than land) for the trade, and the asset is subsequently leased to the trader, a tax deduction is not available for the rent in so far as it exceeds a commercial rent. There are similarities, therefore, between this section and section 779, which applies to a sale and leaseback of land. The section applies to taxpayers within Case II of Schedule D as well as traders. Where section 782 applies, section 781 does not also apply.

Analysis

For example, a trader owns a machine that cost £25,000. On 1 July 2000, the trader sells the machine to another dealer for £15,000 and takes a leaseback for rents of £12,500 payable on 1 July 2000, £6,000 payable on 1 July 2002, £5,500 payable on 1 July 2003 and £1 p.a. payable thereafter. The market value on 1 July 2000 is £17,500 and the commercial rent is £2,500 p.a. Under section 782, the tax relief would be restricted to £2,500 p.a.

It will be seen from this example that the section is directed at schemes that provide for front-loaded rentals, which no longer benefit traders from the tax point of view in any event. The Inland Revenue recognises that this section applies only after other rules for determining deductions have been taken into account.[17]

Conclusion

The section is only expressed to apply to taxpayers within Case I or II of Schedule D, to whom section 42 FA 1998 now applies. It would seem that the section may no longer be required.

17. Section 786 ICTA 1988

History

The section was introduced by FA 1969.

Introduction

This section applies with respect to any transaction effected with reference to the lending of money, or giving credit or enabling or varying the terms of such lending or credit.

If the transaction provides for the payment of an annuity or other annual payment, not being interest, it is deemed to be interest for tax purposes.

Where under the transaction a person assigns, surrenders or waives income arising from any property (without a sale or transfer of that property), he is still charged to tax on that income.

Analysis

The section 'is designed to frustrate artificial arrangements for dressing up interest in another form'.[18] It would apply, for example, where a person is not entitled to tax relief for interest and therefore transfers income-bearing securities to a 'lender' in order to achieve a similar economic result to paying interest. The intention by the 'borrower' would be to avoid tax on the income to achieve a tax advantage compared with paying disallowed interest. The section would also apply if interest were transmuted into an annuity or other annual payment for tax reasons.

This is clearly a section that potentially has a wide scope.

In para. 7 of the ICAEW memo 'Taxation Representations (Miscellaneous Matters) – 1993' (TAX 17/93), it was stated that section 786(5) 'could apply to bona fide corporate transactions including the straightforward refinancing of an insolvent company involving waivers of accrued interest'. The Inland Revenue replied,

[17] See Business Income Manual (BIM) para. 61265.
[18] See IM para. 3943.

> We continue to regard the subsection as aimed at situations involving tax avoidance. Although we cannot rule out in principle its potential application to cases involving corporation tax rather than income tax, we would in practice expect this to be exceptional given the relatively less restricted relief available for interest expense of companies. We would not expect to invoke the provision in the sort of case cited by the Institution – bona fide reorganisation and straightforward refinancing of insolvent companies.

Conclusion

This section should be expressed to apply only where there is tax avoidance. It is not satisfactory if this limitation is operated by the Revenue but not reflected in the statute since, in particular, it gives the Revenue the sole right to interpret what 'avoidance' means for this purpose. It should also be expressly provided (along the lines of section 703) that counteraction under this section should only be by assessment of the amount required to negate any tax advantage otherwise arising.

It should also be noted that if artificial distinctions in tax law between annuities, annual payments and interest are abolished, and companies simply pay tax on their profits, the need for the section would also be reduced.

18. Section 787 ICTA 1988

History

This section was introduced by FA 1976.

Introduction

Where interest is paid under a scheme or arrangement the sole or main benefit of which is the obtaining of a reduction in tax liability, no relief is given for the interest payment.

Analysis

The section was specifically amended by FA 2002 to make clear that it could apply to deny relief for a debit for interest arising on a loan relationship – before that amendment, it was strongly arguable that the section had no application to interest due under loan relationships because relief under those sections does not normally depend on the interest being paid.

This section now clearly overlaps with para. 13 schedule 9 FA 1996, but there is no reason why para. 13 should not set out the complete code for denying tax relief for interest on loan relationships. If it is considered necessary to retain the provision for interest that does not arise on loan relationships, then it should be restricted to this situation.

Conclusion

The section is not required in its current form for companies because of para. 13 schedule 9 FA 1996.

CONCLUSION

The above analysis leads to the following conclusions about the particular sections mentioned:

- Sections 703–709 ICTA 1988 – inappropriate in its current form for company taxation; if it is to be re-enacted in a Corporation Tax Act, the mischief at which it is directed needs to be identified.
- Section 730 ICTA 1988 – should be abolished.
- Section 730A ICTA 1988 – should be simplified.
- Sections 731–734 ICTA 1988 – should be retained (in so far as applicable to companies).
- Section 736 ICTA 1988 – should be abolished.
- Sections 736A, 736B, 737A and schedule 23A ICTA 1988 and section 97 FA 1996 – should be retained in so far as they apply to companies.
- Sections 747–756 ICTA 1988 – should be retained.
- Sections 757–764 ICTA 1988 – serve no sufficient purpose in company taxation.
- Sections 768, 768A, 768B, 768C, 768D and 768E ICTA 1988 – could be substantially simplified and rationalised following abolition of the schedular system.
- Section 770A and schedule 28AA ICTA 1988 – should be retained.
- Section 774 ICTA 1988 – should be retained (although perhaps amended).
- Section 776 ICTA 1988 – should be substantially restricted to 'diversion schemes'.
- Section 779 ICTA 1988 – should be substantially restricted in an accounts-based system of tax.
- Section 780 ICTA 1988 – could be abolished in an accounts-based system of tax.
- Section 781 ICTA 1988 – could be abolished in an accounts-based system of tax.
- Section 782 ICTA 1988 – could be abolished.
- Section 786 ICTA 1988 – should be expressly restricted to tax avoidance.
- Section 787 ICTA 1988 – should be restricted to interest not arising under loan relationships.

It is recognised that opinions may differ in relation to the above analysis of the detailed sections. It is hoped, however, that the analysis demonstrates that there should be a review of the anti-avoidance legislation before it is re-enacted in a Corporation Tax Act.

It is understandable that the Revenue may be reluctant to see anti-avoidance legislation removed from the statute book. It is under pressure to enforce the collection of tax and there is no benefit from being, or being seen to be, soft on avoidance. It is submitted, however, that current anti-avoidance legislation should be repealed in the absence of an explanation, perhaps by reference to precedents available to the Revenue, why it is needed. It is also submitted that it should be modified if it is mandatory but nevertheless not generally applied by the Revenue, and/or results in double taxation, and/or could be limited in its scope yet still address the mischief. It is further submitted that, by taking steps to align and define the relationship between accounting and taxable income, the potential arises to achieve further significant rationalisation and simplification of anti-avoidance tax rules.

ANNEX: CASE AUTHORITIES – SECTIONS 703–709 ICTA 1988

Bonus issue followed by repurchase

CIR v Parker HL 43 TC 421

A company effected a bonus issue of shares to an individual shareholder followed by a repurchase of those shares in an attempt to avoid the tax liability that would have fallen on the shareholder if the company had paid a dividend. The scheme was defeated by countervailing action under section 703 on the individual, however. The case occurred before the enactment of sections 210–211 ICTA 1988, which now apply specifically to defeat such a scheme.

Section 703 would not normally have applied to a company shareholder in these circumstances, since a company does not pay tax on dividends received from another UK company unless it is a trader. Although, in the absence of sections 210–211, a company that is trading might have derived an advantage from the scheme if not all the repurchase price represented taxable profit, the introduction of sections 210–211 denies any such advantage.

CIR v Brebner HL 43 TC 705

The facts of this case were similar to those in Parker above, but the question for the court was whether the taxpayer had a bona-fide motive for the transaction.

This case authority would not be relevant to a company shareholder for the reasons mentioned in Parker above.

CIR v Goodwin HL 50 TC 583

The facts of this case were similar to those in Brebner above. The question for the court was similarly whether the taxpayer had a bona-fide motive for the transaction.

This case authority would not be relevant to a company shareholder for the reasons mentioned in Parker above.

Sale or transfer of shares followed by dividend

CIR v Cleary HL 44 TC 399

Two taxpayers held shares in G Ltd, which had accumulated profits of £180,840 and substantial cash. They sold another company, M Ltd, to G Ltd for £121,000. Section 703 applied because the sale proceeds were held to be received in connection with the distribution of profits of G Ltd.

This case authority would not be relevant to a company shareholder that is not a trader, because the company shareholder would not be liable to tax on a dividend paid out in the ordinary way. A trading shareholder would, of course, be liable to tax on the sale proceeds.

CIR v Brown CA 47 TC 217

The facts of this case were similar to those in Cleary above, save that the company with the profits needed to borrow to fund the purchase price.

This case authority would not be relevant to a company shareholder for the reasons mentioned in Cleary above.

Clark v CIR Ch D 52 TC 482

The facts of this case were also similar to those in Cleary above, but the question for the court was whether obtaining a tax advantage was a main object of the transaction.

This case authority would not be relevant to a company shareholder for the reasons mentioned in Cleary above.

Complex schemes involving development properties

Anysz v CIR Ch D 53 TC 601

The taxpayers held shares in a company that owned properties suitable for development which would earn a substantial profit. A complex sequence of transactions included the exchange of shares in this company for shares in another company and the payment of a dividend by the first company to the second company under a group income election.

If the original shareholder had been a company, the dividend could have been paid to it tax-free without the need for a scheme, unless it were a trading company. It is perhaps less likely that a trading shareholder would have embarked on such a complex series of transactions, but such a shareholder would, in any event, be liable to tax on the share-for-share exchange if that were effected for tax avoidance reasons.

Williams and Others v CIR HL 54 TC 257

This case was similar in its essentials to Anysz, although one difference was that amounts representing the development profit reached the taxpayers as interest-free loans from the company they subsequently acquired.

Section 703 would not be required for a company shareholder in this situation for the reasons given in Anysz above.

Bird and Others v CIR HL 61 TC 238

A company owned property that it wished to sell. 70% of its shares were held by another company and 30% by the Church Commissioners. A complex scheme was effected involving the sale of the property and the payment of abnormal dividends.

Section 703 would not be required for a company shareholder in this situation for the reasons given in Anysz above.

Other complex schemes

CIR v Garvin HL 55 TC 24

Under a complex avoidance scheme, five companies paid abnormal dividends. The companies were first owned by three shareholders but they had disposed of the shares before the dividends were paid. It was held there was not a sufficient link between those dividends and earlier restructuring operations for section 703 to apply.

Section 703 would not be required for a company shareholder for reasons similar to those in Anysz above.

Emery v CIR Ch D 54 TC 607

The scheme employed was similar to that in Garvin above.

Liquidation cases

Joiner HL 50 TC 449

This case concerned the avoidance of a dividend receipt by first putting a company into liquidation and then having its business transferred to a dormant company, with surplus assets being distributed to the shareholder.

A company shareholder could have received a dividend tax-free, unless it were a trader, in which case it would not have saved tax had it liquidated the other company.

Addy v CIR Ch D 51 TC 71

A company was liquidated and its trade transferred to another company, its accumulated revenue and capital reserves being distributed to its shareholders.

This case would have been relevant to a company shareholder for the reasons mentioned in Joiner above.

Marks v CIR CA [1973] STC 541

This was another liquidation scheme – the tax appeal was on the basis that the liquidation was not valid, but the appeal was dismissed.

Miscellaneous cases

CIR v Wiggins Ch D 53 TC 639

A company had acquired for £50 a painting which turned out to be a Poussin worth £130,000. The company transferred its other trading assets to another company owned by the same shareholders. A third party then acquired the shares in the first company for £44,447 (the price reflecting the expected tax consequences of the transaction). It was held that section 703 applied to the shareholders because the company could have sold the painting and distributed the profit by way of a dividend. The sale proceeds were therefore taxed as if they were a distribution received by the shareholders.

It was recognised by the judge (Walton J) that it might be hard on the taxpayers, having accepted a low price for their interest in the shares of the company, to find that they are treated as having received that sum subject to tax.

This case would not be relevant to an investing corporate shareholder, since it could have received the dividend tax-free. It is possible that it could have been relevant to a trading corporate shareholder. It is not clear, however, why such a shareholder should have been liable to tax on an amount that exceeded its trading profit in circumstances where it had not diverted the opportunity to make a tax-free profit to a third party (because the purchaser inherited the low acquisition cost of the painting within the company that had been bought).

CIR v Kleinwort Benson Ltd Ch D 45 TC 369

A merchant bank that dealt in securities purchased debentures with the expectation, subsequently realised, that the debentures would be repaid in full with all arrears of interest. The Inland Revenue proposed to credit the Case I computation with the full value of the debentures resulting from the payment of arrears of interest. It was held that obtaining a tax advantage was not a main object of the transaction and, further, no adjustment under section 703 would be appropriate in any event. There was no fall in value of the debentures as they had ceased to exist.

Unlike most decided cases on section 703, the taxpayer was a company. It was held, however, that section 703 did not apply in this situation.

Greenberg v CIR, CIR v Tunnicliffe HL 47 TC 240

The issue in this case was one of timing – an agreement for the sale of shares was made before 6 April 1960, but the dividends were paid after that date. It was held that section 703 nevertheless applied.

The case would not, in any event, have been relevant for a corporate shareholder.

Laird Group plc v CIR HL [2003] STC 240

The company received an abnormal dividend from a subsidiary which was franked investment income. This enabled the company to pay a large dividend to its own shareholders. It was held, however, that the payment of the dividend to the company was not a transaction in securities, and that section 703 did not apply.

The case has become less relevant, in any event, with the abolition of ACT.

Sheppard and Another v CIR (No. 2) Ch D [1993] STC 240

A bonus issue of shares was renounced in favour of trustees of a charity, and the charity was able to redeem the tax credit on the dividend. It was held that the charity did not obtain a tax advantage within the meaning of section 703.

This case would not be relevant to a corporate shareholder which is not a charity.

Sema Group Pension Scheme Trustees v CIR 74 TC 543

This case involved a claim by trustees for a tax credit on a payment that was treated as a distribution for tax purposes. It was held that the distribution was not abnormal for section 703 purposes.

The case would not, in any event, be relevant to a company that was not exempt from tax.

CHAPTER 4

GROUP RELIEF – SCHEDULE 18 ICTA 1988

PRELIMINARY

The rules now appearing in schedule 18 ICTA 1988 were first introduced by FA 1973, although significant amendments have been made subsequently, such as the provisions for option arrangements in 1992. The substance of the schedule 18 rules is that a parent company not only requires at least 75% by nominal value of the ordinary share capital of a subsidiary for group relief, but also an entitlement to at least 75% of the profits of the subsidiary and of the assets of the subsidiary available for distribution to all 'equity holders' in the subsidiary. Further, for relief to be available in the current accounting period, these conditions must be satisfied not only in the current accounting period but also, having regard to such matters as varying share rights and option arrangements, in future accounting periods.

The rules have been developed and modified over the years, but problems and inconsistencies remain, and it seems that they still leave scope for tax planning which the draftsman would not have intended. The legislation is lengthy and complex, and the discussion that follows is necessarily therefore also lengthy and detailed. In this discussion, the more important points might be obscured by the detail, so they are separately summarised in the Conclusion.

The Annex to this chapter illustrates how the legislation might appear if the suggestions made in this chapter were to be adopted. In common with the discussion below, the Annex addresses only group relief and not consortium relief, and would need to be adapted to apply to consortium relief as well. It will be seen that the Annex is substantially shorter than the existing law.

ANALYSIS

(References to paras are references to schedule 18 ICTA 1988, and references to sections are references to ICTA 1988, unless otherwise stated.)

1. Profits available for distribution

(a) Para. 2(1) provides that the percentage to which one company is beneficially entitled of any profits available for distribution to equity holders of another company is the percentage to which the first company would be entitled in the current accounting period on a distribution to all equity holders of the total profits of the company that arise in that accounting period. If the second company has no profits in the accounting period, it is deemed to have profits of £100 for this purpose.

(b) 'Total profits' are not defined for corporation tax purposes, but 'profits' are defined in section 6(4) to be, save where the context otherwise requires, income and chargeable gains (i.e. profits as computed for tax purposes). It would seem the context does require otherwise in schedule 18 since it is intended to set out a test for economic ownership by means of a notional distribution of actual profit. The accounting profits serve this purpose better than tax profits (which could, of course, be very different). This view is reflected in the Revenue Corporation Tax (CT) Manual. The position is complicated, however, by the introduction of para. 2(1A) by FA 2000, which provides that the total profits of a non-resident company shall be determined for this purpose as if it were UK resident. This is a tax provision that would be irrelevant if the test were accounting profits.

(c) It is suggested that the law should make clear that the profits to be apportioned are the accounting profits determined in accordance with GAAP, and that all such profits shall be deemed to be distributable for the purpose of the test. As mentioned in Revenue CT Manual para. 2734, amounts attributable to equity holders (such as interest on loans that are not normal commercial loans) that have been deducted in the computation of accounting profits should be added back. Any profits attributable to fixed-rate preference shares should then be deducted to determine the profits to be apportioned amongst equity holders. While it is Revenue practice that these steps should be carried out, it is doubtful that the practice is supported by the legislation, which, as stated above, requires an apportionment of the 'total profits of the company' to be made amongst equity holders. Of course, the level of profit (and the asset calculation discussed below) could be affected by such matters as the introduction of International Accounting Standards. Any further adjustment to accounting profit as so determined under IAS that may be required could also be reflected in the profit definition. It seems worth taking this trouble to define profits properly in the legislation since the notional distribution of profits (and assets) underlies the whole schedule 18 approach.

(d) Para. 2(2) says that it is assumed that no payment is made by way of repayment of share capital or principal of a loan unless that payment is a distribution, and para. 2(3) says that, subject to para. 2(2), where an equity holder is entitled as such to a payment that apart from para. 2(3) would not be treated as a distribution, it shall nevertheless be treated as an amount to which he is entitled on the profit distribution. It is suggested that these provisions confuse (as well as complicate) the test, because they make relevant the tax issue of whether a payment is treated as a distribution for tax purposes. This could depend, for example, on whether the payment is made to a company or to an individual, or the circumstances in which share or loan capital was first issued (even though the share or loan capital might be owned by a different person at the relevant time from the person to whom the share or loan capital was first issued). The test should be left as a simple economic test of who is entitled to the notional distribution of profit on the assumption that capital is not repaid on shares or loans.

(e) The £100 notional profit is discussed in paras 5(b)–(c) below.

(f) Section 413(7)(a) provides that in order to test whether the profits test is satisfied at any time, the parent company must be entitled to at least 75% of the profits at that time in accordance with schedule 18. Schedule 18 provides the rules for who is entitled to the profits in the accounting period, but does not provide a test for each point in time. It does not set out the position if equity holdings are acquired or disposed of in the accounting period in question, or the position if the entitlement varies in that accounting period. (Para. 5 only addresses the position if the notional distribution takes place in a different accounting period.) Indeed, it would appear on a strict construction of schedule 18 that, contrary to the accepted position, a person who sold a 75% equity holding one month after the beginning of an accounting period would not be entitled to group relief for that one-month period because he would not be entitled to 75% of the profits for the accounting period. Where rights vary during an accounting period (if, for example, a third party loans money for a few months in an accounting period and the loan is not a normal commercial loan), it is not clear whether an equity holder would be denied group relief for those few months if his entitlement then fell below 75%, even though his entitlement over the whole accounting period exceeded 75%. (The position in a similar situation in relation to consortium relief is clear by virtue of section 403C(9) – one takes the weighted average of the profit entitlement over the period.) It would seem that this point is worth addressing in any revision of schedule 18.

2. Assets available for distribution

(a) It is suggested that an express statement that the proportion of assets attributable to equity holders on a notional distribution should be based on the accounts prepared in accordance with GAAP would also be appropriate.

(b) Naturally, this test could result in a different answer if IAS were adopted, in view of the greater chance of assets being shown at fair value in those accounts. This would normally have the result of increasing the asset percentage attributable to equity shareholders rather than equity holders who are loan creditors, but would perhaps reflect more closely their actual economic entitlements.

(c) If there are no actual assets attributable to equity holders, para. 3(1)(b) deems there to be such assets of £100. This rule is discussed further in paras 5(b)–(c) below.

(d) An anti-avoidance provision is required (as is currently provided) to prevent the boosting of the percentage entitlement on the assets distribution by subscribing for an equity holding and having the company use the money to lend back to, or subscribe for shares in, the equity holder.

3. Normal commercial loan

(a) An equity holder is defined to include a loan creditor if the loan is not a normal commercial loan. Three conditions need to be satisfied for a loan to be a normal commercial loan.

(b) Perhaps the most commonly encountered condition is that a loan will not be a normal commercial loan if the loan creditor is entitled to an amount by way of interest which depends to any extent on the results of the company's business or on the value of the company's assets, or exceeds a reasonable commercial return (see paras (5)(b) and (5E)–(5H)). This test is in contrast to section 209, which provides that interest on a loan is treated as a distribution if the amount depends upon the results of the business, with no mention of the value of assets being relevant.

(c) Although interest on a loan that is not a normal commercial loan may not be a distribution for tax purposes, it is also the case that interest on a loan may be treated as a distribution even though the loan is a normal commercial loan. Section 209 provides, for example, that interest on securities 'connected with shares' in the company is treated as a distribution, but there is no corresponding provision in schedule 18 for deeming the loan not to be a normal commercial loan in this situation.

(d) There seems no sufficient policy reason to distinguish between the normal commercial loan test and the distribution test in these ways. It is suggested that, for the sake of clarity, simplification and convenience, the two tests should be aligned.

(e) A similar point can be made in relation to the second condition. Complex rules (see paras (5)(a) and (5A)–(5D)) provide that a loan is not a normal commercial loan if the loan has rights to convert in future into a loan that is not a normal commercial loan or into shares that are not fixed-rate preference shares, save that conversion rights into shares of a parent company in certain circumstances do not prevent a loan being a normal commercial loan. Further, the loan must confer no rights to acquire additional shares or securities.

(f) It is very doubtful that this complexity is justified, particularly now that the rules for option arrangements have been introduced. It may be possible for the parties to avoid 'conversion rights' in a loan by providing in a separate subscription agreement that any proceeds of redemption of the first loan are to be reapplied in specified circumstances for the new security. It may be hard to argue that the first loan had 'conversion rights' in this situation. It may also be possible to avoid a loan having 'conversion rights' for shares in another company by having the loan creditor enter into an agreement with that other company to exchange his loan for shares in that company. Again, it would be hard to argue that this loan had 'conversion rights', since in this case the debtor company would not even be a party to the arrangement. Further, since 'option arrangements' to acquire an equity holding were brought within the scope of the schedule 18 rules in 1992, the ability of a loan creditor to acquire an equity holding in the same or a different company by means of conversion rights is already taken into account so as potentially to diminish the percentage shares of other equity holders in that company.

(g) It also seems correct in principle that a person is treated as an equity holder only of that company in which he may acquire an equity holding. Reference is made in this connection to the Inland Revenue Press Release of 6 July 1989. This was issued at the time that the rules were relaxed so that a loan to a subsidiary could still be treated as a normal commercial loan even if it was convertible into shares of the parent, provided the parent's shares were quoted. (The rules had previously applied to catch many straightforward Eurobonds.) The Press Release confirmed that the object of schedule 18 was to establish the true economic ownership of the company. It did not explain, however, how in any event a conversion right into the parent's shares could mean that the subsidiary is not truly owned by the parent. The object of schedule 18 is to test whether the parent and the subsidiary are under different ownership, and conversion rights into the parent's shares preserve the group relationship between the parent and the subsidiary.

(h) It is therefore suggested that the conversion rights rules in schedule 18 and the section 209 rules also be conformed so that where interest on a convertible loan is treated as a distribution for tax purposes, the loan is not a normal commercial loan for schedule 18 purposes. If, by reason of the loan being issued on terms that are comparable to listed securities, interest on the convertible loan is not treated as a distribution, the loan would be a normal commercial loan. In either case, however, the holder of the loan could have option rights to acquire an equity holding, and these are now taken into account as a separate test under schedule 18. It is noted that section 209 applies to treat interest as a distribution where the loan is convertible into shares of the issuing company, and does not apply where it is convertible into shares of another company, and it is similarly suggested that rights to convert into an equity holding of a different company should not prevent a loan being a normal commercial loan.

(i) The third condition for a normal commercial loan is that the loan creditor is entitled, on repayment, to an amount that either does not exceed the new consideration lent or is reasonably comparable with amounts generally repayable under the terms of listed securities. The language used differs from the language of section 209, which provides that any consideration for the use of the principal, whether or not it is 'interest', that exceeds a reasonable commercial return is treated as a distribution. Section 209 does not, however, expressly permit a comparison to be made with quoted securities to determine whether a repayment amount is excessive. The objective seems to be the same, however, and it is suggested therefore that the language be conformed.

(j) Para. 1(6) may apply where a person has directly or indirectly provided new consideration for any shares or securities in a company, and that person or any person connected with him uses, for the purposes of a trade, assets that belong to the company. If the company is entitled to first-year or writing-down plant and machinery allowances, or research and development allowances, in respect of the assets, the person, and no other, shall be treated as an equity holder in respect of the shares or securities.

(k) This rule is clearly intended to restrict the ability to pass tax relief from the person to a different group of companies when the person is effectively funding the acquisition cost of the assets in question. It should be noted, however, that no restriction is encountered if the company that owns the asset is the 'top' company in the group (i.e. it is not a subsidiary which might be degrouped by this provision), or if the company has sufficient other profits of its own to absorb tax losses arising from the capital allowances. The rule might apply if a special purpose subsidiary is established to lease the asset, but there is likely to be little reason to establish such a subsidiary rather than using an existing company that has other profitable business or its own profitable subsidiaries, having regard to the rule that it must in any event be controlled by the parent company for group relief to be available (section 410). In other words, it is usually easy to avoid para. 1(6) applying. Further, there is no restriction under para. 1(6) if the user of the asset is not a trader, and it is hard to understand why the same mischief is not thought to apply in such a case. Also (unless the lender is a bank – see para. 1(7)), there is no connection required between the issue of the securities and the funding of the assets – the provision has exactly the same consequences for a person who subscribes £1,000 for a loan or fixed-rate preference shareholding as for a person who subscribes £100 million, even if the asset used by that person only costs £100. The loan or fixed-rate preference shareholding is all treated as an equity holding. This is a form of legislative 'overkill' which does nothing to encourage taxpayers to comply with the spirit of tax legislation.

(l) It would appear that, to be more accurately targeted, the provision should be for the restriction of capital allowances to the extent that the acquisition cost of the asset is directly or indirectly provided by the person to the company. This might be achieved by means of a modification to section 532 CAA 2001 such that, for the purposes of that section, 'contributions' include amounts subscribed for share or loan capital by a person using the asset, or a person connected with him.

4. Fixed-rate preference shares

(a) Similar points can be made in relation to aligning the definition of fixed-rate preference shares with shares that are not ordinary share capital.

(b) Ordinary share capital is defined in section 832(1) as all issued share capital except capital the holders of which have a right to dividends at a fixed rate but no other right to share in the profits of the company. It would be possible, however, to define ordinary shares as shares that are not fixed-rate preference shares. This could also resolve the existing anomalous position that shares that carry no rights to dividend are regarded as ordinary shares within section 832 but as fixed-rate preference shares for the purposes of schedule 18. For the purposes of schedule 18, however, it is also appropriate to include fixed-rate shares that provide an excessive commercial return within the definition of ordinary shares.

5. Limited rights

(a) Para. 4 applies where an equity holder's shares or securities have rights in respect of income or in respect of assets on a notional winding-up which are limited by reference to a specified amount or amounts. In this situation, the rights of all equity holders are determined as if the limited rights attaching to such shares or securities had been waived.

(b) This provision is intended to prevent avoidance by, for example, a company holding a special class of ordinary shares in a loss-making company that entitles it to 80% of the profits up to £100 available for distribution to shareholders, but to no further share of profits that exceed £100. Since the loss-making company is deemed to have profits of £100, the 75% test would be satisfied and, in the absence of this provision, the two companies could form a group if the nominal value of the special class of shares constituted not less than 75% of the total. As a result of para. 4, the entitlement of the special class of shares is calculated as if the limited rights had been waived, i.e. as if the equity holder had no entitlement to any dividend.

(c) It seems, however, possible to avoid this rule by having the special class of shares given rights according to a formula, whose rights rapidly diminish as profits increase, but without any specified limit as such. The formula for the special class of shares could be, for example, that they are entitled to 20*x* divided by the square root of (*x* plus 400), where *x* is the total profit of the company. This would give the desired diminishing return without having a limit as such – where profits are £0, £1, £100 and £1,000,000 respectively, the formula gives entitlement to the special class of shares of £0, £0.99, £89 and £19,996 respectively. On this basis, it becomes possible to have a loss-making company (which is deemed to have a profit of £100 for distribution to equity holders) artificially grouped with another company holding the special class of shares. It would seem that a satisfactory solution to this problem may be to provide that, in order for a company to be in the group, the 75% test must be satisfied not only in relation to actual profits but also in relation to any higher figure of profit. In this way, it is also possible to dispense with the somewhat arbitrary deemed profit of £100 for a loss-making company. The 75% test for a loss-making company would have to be satisfied for any figure of profit. Similar considerations also apply to the assets test.

(d) The Inland Revenue CT Manual confirms (at para. 2739) that the limited rights rule is also intended to ensure that the 75% test must normally be satisfied even if the parent company waives all rights in respect of loans that are not normal commercial loans, because the rights of such loans are normally limited. Where, for example, a convertible loan carries interest at 8%, the 8% interest is a limited right, or where a loan is repayable at par, that is a limited right on a distribution of assets. Two points may be made in this connection. First, this could at present be seen as a trap for the unwary, because it may not be immediately apparent that the legislation has this effect. Second, it does appear to make sense to add back the interest due on a loan that is not a normal commercial loan to determine the profits attributable to equity holders, and then to determine how that amount is apportioned to other equity holders on the assumption that the interest has been waived. The above suggestion for dealing with limited rights would appear to resolve these problems.

6. Variable rights

(a) Para. 5 applies where the rights of an equity holding could vary in different accounting periods. If the percentage profit entitlement or percentage asset entitlement could be lower as a result in that accounting period, that lower percentage entitlement is deemed to apply in the current accounting period.

(b) The legislation appears to apply even if the difference could occur only in an earlier accounting period, in which case a lower percentage attributable to that earlier period would be deemed to apply in the current accounting period. It is suggested that this is incorrect in principle, and only future possible changes should be taken into account.

7. Option arrangements

(a) Para. 5B provides that possible future changes to entitlements to the profit share or assets share as the result of option arrangements may deny group relief in the current accounting period.

(b) Thus, where the exercise of a call or a put option to acquire shares or a loan (other than fixed-rate preference shares or a normal commercial loan) could result in the 75% profit or asset test being failed at some time in the future, the 75% profit or asset test is deemed to be failed in the current accounting period. It should be noted that only legally binding option rights could give rise to such arrangements. (So, as a drafting point, it might be preferable to avoid the use of the words 'option arrangements' in schedule 18, because certain arrangements for a change of control of a company that are not legally binding can defeat group relief under section 410.) Certain employee share options granted under Revenue approved schemes are ignored for schedule 18 purposes. Extra Statutory Concession C10 also provides that certain arrangements applying to shareholdings in joint venture companies do not constitute option arrangements until one or more triggering events occur, such as the change of control or the insolvency of one of the partners.

8. Combinations of variable rights and option arrangements

(a) It is when addressing the possibility of combinations of variable rights, limited rights and option arrangements, however, that the legislation becomes even more prolix without apparently achieving the 'right answer'.

(b) Para. 5E provides that, where equity holdings are subject to variable rights and equity holdings are subject to limited rights and option arrangements are also present, it is necessary to carry out eight separate calculations for the profit test to recognise all possible combinations taking any one, any pair, all three or none of these possible future changes into account. A further eight calculations are required for the assets test. Paras 5C and 5D provide for four separate tests if only two out of variable rights, limited rights and option arrangements exist.

(c) Suppose, however, that a company has issued, for example, two classes of shares, one of which ('Class B') entitles the shareholder to 20% of the profits of the company for a five-year period, and then carries no profit entitlement, and minimal rights in any liquidation. The other class ('Class A') entitles the owner to the balance of profits and assets after the Class B entitlement. If a company owns the Class A shares, then clearly the two companies can be in the same group for tax purposes. Suppose, however, that it is also provided that the owner of the Class B shares has the option after year 5 to subscribe for up to 20% of the enlarged class of Class A shares in consideration of an agreed subscription price. Common sense would suggest that this option should not defeat the group relationship because at no time could the Class B shareholder become entitled to more than 20% of the company's profits. Para. 5 appears deliberately to provide, however, that the group relationship is defeated because one has to take into account in one of the calculations the variable rights and the option arrangements as if they could both apply at the same time.

(d) This point is resolved if the legislation simply provides that the group relationship is not satisfied if it is possible, having regard to the existence of the variable rights and the option arrangements, that at any future time the 75% condition would not be satisfied. (If the suggestion made at para. 5 above were to be adopted, it would not be necessary to retain the current test for limited rights.) The legislation could also then be substantially shortened and simplified.

9. Foreign companies

(a) Para. 5F is an avoidance provision which was introduced when group relief was extended in FA 2000 to apply a UK trade conducted by a foreign resident company, which can now be grouped with UK resident companies. It is designed to prevent group relief where, although the foreign subsidiary is genuinely part of the group, third parties have equity holdings referable to the UK trade that mean that the economic ownership of the UK trade is not the same as the economic ownership of the foreign subsidiary. It is assumed therefore that the non-resident company has a form of 'alphabet stock', with different securities having rights that are attributable to different businesses. It may be relevant to note that such arrangements are rarely pursued in the UK, whether for commercial purposes or not (although they are sometimes used in the US), because they are extremely complicated to draft and to negotiate.

(b) The drafting is complex, however, and in places confusing. For example, para. 5F(7)(a) provides that an alternative profit distribution and asset distribution test is to be made on the assumption that these distributions are confined to the profits and assets respectively attributable to the UK trade. It appears that this reference to the profit attributable to the UK trade should be construed as a reference to the accounting profit. If that profit exceeds the greater of the tax profit attributable to the UK trade or £100, the greater of such tax profit or £100 is the amount that is deemed to be distributed. This does not, however, appear to produce a rational result. In particular, it does not provide (as one would expect) that if there are losses attributable to the UK trade, there is deemed to be a profit distribution of £100.

(c) The Annex to this chapter contains an attempt to draft the required provision more succinctly. It assumes that the profit and asset tests are determined by reference to accounts prepared under UK GAAP, save where the company adopts IAS, in which case it is IAS GAAP, in accordance with section 50 FA 2004. Where the foreign accounts do not comply with UK or IAS GAAP, amendments to those accounts would then be required.

CONCLUSION

1. New definitions of profits and of assets attributable to equity holders should be provided.

2. The definition of loans that are not normal commercial loans in schedule 18 should be aligned with the definition of loans on which interest is deemed to be a distribution. The definition of shares that are not fixed-rate preference shares in schedule 18 should be aligned with the definition of ordinary share capital.

3. The concept of the entitlement of shares or loans with limited rights being determined as if those limited rights were waived should be replaced with the concept that the holder has the minimum percentage entitlement to profits or assets that would apply if the profits or assets were greater than they actually are.

4. The possible effects of variable rights and option arrangements at any future time should both be taken into account, but the possible effects of variable rights at any future time should not be taken into account together with the possible effects of option arrangements at any other future time.

5. The legislation can be substantially simplified.

ANNEX: A REVISED VERSION OF SCHEDULE 18

1. This schedule determines whether the condition mentioned in section 413(7)(a) ('the profits condition') and the condition mentioned in section 413(7)(b) ('the assets condition') are satisfied in relation to a 75% subsidiary company ('company A') of another company ('company B') at any time ('the relevant time').

2. (a) Subject to paras 4–8, the profits condition is satisfied at the relevant time if company B would be entitled on a distribution of any profits that are attributable to equity holders of company A to at least 75% of such profits. This entitlement shall be calculated on the assumption that the ownership of equity holdings at the relevant time is unchanged throughout the relevant interval.

   (b) For this purpose, the profits attributable to equity holders of company A are its accounting profits for the relevant interval, after adding back profits attributable to loans that are not normal commercial loans and after deducting profits attributable to fixed-rate preference shares. The accounting profits for a relevant interval falling within an accounting period shall be determined from the profits of that period by apportionment in accordance with section 403B. All accounting profits of company A shall be deemed to be distributable, and any rights of an equity holder to the repayment of share or loan capital from such profits of company A shall be deemed to have been waived.

3. (a) Subject to paras 4–8, the assets condition is satisfied at the relevant time if company B would be entitled on a distribution of any assets attributable to equity holders of company A on a liquidation of company A to at least 75% of the value of such assets.

   (b) For this purpose, the assets attributable to equity holders of company A have the value that is shown as attributable to shareholders in the accounts of company A at the end of its accounting period that is current at the relevant time, after adding back the value of assets attributable to loans that are equity holdings at the relevant time, and after deducting the value of assets attributable to fixed-rate preference shares at the relevant time that remain in issue at the end of the accounting period.

   (c) An amount equal to any part of any new consideration subscribed for an equity holding in company A which is applied by company A directly or indirectly in making a loan to, or subscribing for any shares, in company B, or any person connected with company B, shall be deducted in the calculation of assets attributable to equity holders of company A and of the amount to which company B is entitled on a distribution of assets.

4. The amount of profits or the value of assets attributable to equity holders respectively determined under para. 2(b) or para. 3(b) shall be deemed to be £1 where such amount would otherwise be a negative amount.

5. The profit condition and the assets condition shall be satisfied at the relevant time only if they would also be satisfied if the profits or assets available for distribution to equity holders were any amount larger than the amounts determined under paras 2(b) and 3(b).

6. If as a consequence of the variable rights of any equity holding, or the exercise of any option rights, or any possible combination of the variable rights of any equity holding and the exercise of any option rights, the entitlement of company B in respect of a distribution of profits or assets attributable to equity holders could be lower at any time after the relevant time, then the profit condition and the asset condition shall only be satisfied if they would be satisfied if such entitlement of company B at the relevant time was the minimum entitlement that could apply at any later time.

7. If company A is a non-resident company that has a UK trade, the profit condition and the asset condition shall be deemed not to be satisfied at the relevant time if they would not be satisfied on the assumption that the only profits or losses or assets or liabilities of the company were those attributable to the UK trade.

8. The profit condition and the asset condition may be satisfied either directly or indirectly through one or more other bodies corporate, or partly directly and partly indirectly through one or more other bodies corporate.

9. For the purposes of this schedule:

   - 'equity holding' means ordinary shares [defined as suggested above to mean shares that are not fixed-rate preference shares], or a loan in respect of which any payment that is not a repayment of capital may, on the assumption that section 212 does not apply, be treated as a distribution by section 209 [section 209 being modified as suggested above], and 'equity holder' means the owner of an equity holding. Shares shall not be ordinary shares for this purpose, however, if they carry a right to dividends that exceeds a reasonable commercial return on new consideration received for the issue of such shares, or if they carry the right on repayment to an amount that is not reasonably comparable with the right that is general for fixed dividend shares quoted on a recognised stock exchange;

   - an equity holding has variable rights if at the relevant time it carries rights in respect of a dividend or interest or assets on a winding-up that vary, such that the entitlement of the equity holder in respect of the profits distribution or asset distribution could be lower in any later accounting period;

   - 'option rights' means the right at the relevant time of any person to acquire an equity holding or the right of any person to require another person to acquire an equity holding, save that option rights acquired by an individual under a share option scheme at a time when the scheme was approved under schedule 9 shall be ignored for the purposes of this schedule;

- ‘relevant interval’ is the accounting period of company A current at the relevant time, or (where shorter) the maximum interval falling within that accounting period which includes the relevant time during which no equity holdings are issued or cancelled or have their rights varied;

- ‘accounts’ means accounts prepared in accordance with generally accepted accounting practice, and ‘accounting profits’ shall be the profits shown by such accounts.