briefing notes

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REFORM OF CORPORATION TAX:
A RESPONSE TO THE GOVERNMENT'S CONSULTATION DOCUMENT

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1. Introduction

In August 2002, the government issued a consultation document on further reform to the corporation tax system.[1] This consultation is primarily concerned with the calculation of taxable income. The rules of the corporation tax system have evolved over many decades. The consultation is a welcome opportunity to look again at the rules, to see where they are now out of date or inconsistent for no discernible purpose and to update them where necessary.

But this consultation goes beyond a mere tidying of the tax system. Underlying the proposals is a clearly discernible direction for reform of the corporation tax system. The aim is to align taxation and company accounts. Although the consultation addresses three topics – capital assets, the schedular system and the distinction between trading and investment companies – the major issues revolve around the treatment of assets and losses. In the former case, a comprehensive alignment is raised as a possibility. In the latter case, the proposals represent a first step along a road that could eventually lead to taxation on a tax consolidated basis and hence the reduction or elimination of the existing restrictions on how losses can reduce taxable profits.

This response focuses on these larger issues. It aims to explain the main proposals contained in the consultation, to provide some empirical evidence on the scale of possible changes and to make some comments on the wider policy issues that these proposals raise. At this stage of the consultation process, we retain an open mind on the merits of any final reform package, not least because there is a wide range of alternative packages.[2]

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[1] HM Treasury, *Reform of Corporation Tax*, August 2002.

[2] For a full discussion of the issues raised in aligning tax and accounting definitions of income, see G. Macdonald, *The Taxation of Business Income: Aligning Taxable Income with Accounting Income*, Tax Law Review Committee Discussion Paper No. 2, IFS, London, 2002.

2. The tax treatment of capital assets

The consultation addresses the treatment of capital assets. We start by describing how these assets are currently treated by the tax system. We then consider how such assets will typically be treated if the proposed changes take place, i.e. if the tax treatment is to follow company accounts more closely. After presenting some data on typical depreciation rates employed by firms, we consider the implications of moving from the current system to the proposed one.

2.1 The current treatment of assets

For the company, an asset will be bought at some original cost, used for a period of time and then either sold or scrapped. If sold, this can be at either a loss or a gain compared with the original cost. Where the asset is expected to be sold at a loss or scrapped, a provision for depreciation will normally be made in the company's accounts. This depreciation will be charged on an accruals basis, writing down the value of the asset while it is in use. If the asset is expected to be sold at a gain, accruing gains may or may not be recognised in the accounts. When the asset is sold or scrapped, the final gain or loss on the asset will be included in the accounts.

Before considering the actual tax treatment of assets and the proposed reforms, it is helpful to break down the system of taxing assets into a number of elements.

- The tax system may allow some part of the original cost to be written off annually against profits in calculating the company's taxable income. The 'tax written-down value' of the asset will be the original cost of purchase less any amount already written off against profits.

- If the asset is scrapped or sold at a loss relative to the tax written-down value, the tax system may allow this loss to be offset against any income or it may restrict its use so it can only be offset against income from particular sources.

- If the asset is sold at a profit relative to the tax written-down value, the tax system may tax this gain. The gain can potentially be split into three distinct parts, to which different rules may apply:

    i. gains between the tax written-down value and the original cost of the asset, where the government may want to claw back the excess write-off already given; this clearly only applies if the original cost can be written off against profits;

    ii. purely nominal gains over and above the original cost;

    iii. real gains over and above the original cost adjusted for inflation.

Table 1. Current tax treatment of assets

Asset	*Writing off original cost*	*Clawback of excess write-off*	*Loss relative to tax written-down value*	*Nominal gain relative to original cost*	*Real gain relative to original cost*
Plant and machinery (pooled)	25% of tax written-down value each year (i.e. declining balance)[a]	25% of outstanding excess each year	25% of outstanding loss against profits each year	No tax (indexation relief)	Taxed unless rollover into new asset (if qualifying)
Industrial buildings (new)	4% of original cost each year (i.e. straight line)	Immediate	Immediate against profits	No tax (indexation relief)	Taxed unless rollover into new asset
Land and commercial buildings	None	NA	Against capital gain only	No tax (indexation relief)	Taxed unless rollover into new asset
'Insubstantial shareholdings' held as investment	None	NA	Against capital gain only	No tax (indexation relief)	Immediate
Intangible assets	As accounts or 4% of original cost on election	Immediate	Offset against profit immediately	As accounts or rollover into other intangible assets	As accounts or rollover into other intangible assets[b]

[a] There are some exceptions to the 25% rate. For example, long-life (more than 25 years) plant and machinery are only allowed a 6% writing-down allowance. Small and medium-sized firms are eligible for a 40% first-year allowance.

[b] Proceeds must be reinvested in qualifying assets purchased up to one year before or three years after. The base cost of the new asset for tax purposes is reduced by the amount of the deferred gain.

Table 1 summarises how the current system deals with each of these elements for the main classes of assets. A detailed description of this table is given in Annex A. The tax treatment of assets may vary from the accounts treatment in two main ways: any gain, loss or depreciation may be taxed or relieved at a different time from its accounts recognition; certain gains or losses that are recognised may be treated in a different way from other profits or losses (e.g. a capital loss may only be relievable against a capital gain).

As Table 1 shows, only for intangible assets does the tax treatment follow accounts (at least in allowing depreciation), but even here gains on realisation may be deferred by rolling over into other qualifying assets. For tangible assets, the tax system does not allow depreciation as recorded in accounts. Instead, it grants writing-down allowances for those assets that qualify at prescribed rates. Neither accounts depreciation nor capital allowances are necessarily equal to true economic depreciation, i.e. the real fall in the value of an asset.

2.2 The consultation proposals

The consultation document proposes a series of reforms. Essentially these involve moving the treatment of all assets more into line with their treatment in accounts, as has been done for intangible assets in the 2002 Budget. Table 2 shows the proposed treatment of assets.

These proposals can be divided into three:

i. Allowing accounts-based relief for depreciation where no relief is currently allowed (shaded light grey in Table 2). The main assets affected are commercial buildings. Losses on these assets could then be offset against income rather than just capital gains.

ii. Replacing the existing capital-allowance-based relief for depreciation with an accounts-based system (shaded mid-grey in Table 2). The main assets involved are plant and machinery and industrial buildings. This would also potentially affect the way capital losses on plant and machinery are relieved against income.

iii. Taxing gains on assets as they are recognised in accounts (shaded dark grey in Table 2). This would mean both nominal and real gains would be taxed, with the possibility of a new rollover relief.

The consultation document recognises a number of special cases. First, existing ‘enhanced’ capital allowances will be retained, though the form in which they are delivered may change. These include 100% allowances for designated energy-saving technologies and computers purchased by small businesses and 40% first-year allowances for assets purchased by small and medium-sized businesses. The consultation also makes clear that it will examine the case for differential regimes for different types of assets and for certain business sectors, such as life insurance.

Table 2. Proposed tax treatment of assets

Asset	*Writing off original cost*	*Clawback of excess write-off*	*Loss relative to tax written-down value*	*Nominal gain relative to original cost*	*Real gain relative to original cost*
Plant and machinery	As accounts	Immediate with possible rollover	Immediate against profits	As accounts or possible rollover	As accounts or possible rollover
Industrial buildings	As accounts	Immediate with possible rollover	Immediate against profits	As accounts or possible rollover	As accounts or possible rollover
Land and commercial buildings	As accounts	Immediate with possible rollover	Immediate against profits	As accounts or possible rollover	As accounts or possible rollover
'Insubstantial shareholdings' held as investment	As accounts	Immediate	Immediate against profits	As accounts	As accounts

2.3 Accounts depreciation rates

Before discussing each of these proposals in turn, it is helpful to set out the limited available information about the depreciation rates used in commercial accounts. This will be important for assessing both the replacement of capital allowances with accounts-based depreciation and the allowing of accounts-based depreciation where no relief is currently available.

Information on actual rates of depreciation used in accounts is limited, mainly because of restrictions on the available data. It is possible to estimate the average depreciation rates used by non-financial companies over the period 1971–90 for two types of assets: property and 'other' assets. These estimates are shown in Table 3. The average straight-line depreciation rate on all property over this period was 1.8%. For other assets, which are primarily plant and machinery, the average estimated declining-balance depreciation rate was 11.2%.

Table 3. Average depreciation rates for non-financial companies, 1971–90

Sector	*Asset*	
	Property	Other assets
Commercial	1.3%	12.4%
of which Retail	1.1%	14.8%
Industrial	2.0%	12.3%
Property	0.0%	17.2%
Utilities	3.4%	5.9%
Total	1.8%	11.2%

Notes: Calculations based on EXSTAT data covering nearly 4,000 quoted UK companies. The depreciation rates presented are the weighted averages for all companies in each sample. For property, straight-line depreciation is assumed; for other assets, the declining-balance method is assumed. Assets are assumed to be depreciated once a year, starting from the year of purchase.

There was considerable variation in write-down rates by business sector. For example, the average depreciation rate on other assets in the utilities sector was 5.9%, while the property assets of companies in the property sector were generally not depreciated in accounts.

For plant and machinery, which currently receive a 25% writing-down allowance, these data indicate that writing-down allowances were more generous than accounts treatment of depreciation over the sample period. But as these data are already more than 10 years old, it is vital to get some feeling as to how rates have moved over the last decade. Our expectation is that there will have been some increase in depreciation rates, reflecting the increased use of computers with relatively short useful lives. Initial examination of FTSE 100 company accounts suggests that depreciation rates have indeed increased,

although for plant and machinery they are probably, on average, still below the current writing-down rate for capital allowances.

2.4 Consideration of the consultation proposals

We now consider in turn each of the three main proposals – allowing accounts-based depreciation where no relief is currently allowed, replacing capital allowances with an accounts-based system and taxing gains as recorded in the accounts.

i. Allowing accounts-based relief where no relief is currently allowed

The consultation emphasises the need to ensure that 'decision-making is driven by commercial rather than by tax considerations'. It recognises that this means that actual economic costs, such as depreciation, should be relieved. This is the main rationale for allowing depreciation for assets that are currently not covered by capital allowances. The most important assets concerned are commercial buildings.

The proposals envisage that such assets should be depreciated in line with the depreciation charge in the accounts. In so far as this represents the actual fall in value of an asset not currently allowed for tax purposes, the proposal is a sensible rationalisation of the tax system. However, accounts-based depreciation is not the only way to provide relief. An alternative would be to introduce a writing-down allowance for such assets.

The actual cost to the exchequer may be limited, as land and commercial buildings will often be appreciating assets. Table 3 showed that over the period 1971–90, the average rate of depreciation on property companies' property assets was almost zero. Within the retail sector, property was, on average, depreciated in accounts at 1.1% per year.

ii. Replacing capital allowances with an accounts-based system

For plant and machinery, industrial buildings and certain other assets, the tax system already includes capital allowances. These allow the cost of assets to be written off against tax at a rate prescribed in law. Table 4 shows the average amount of capital allowances claimed in 1999–2000. They reduced taxable income by almost £65bn in that year.[3] The most important allowances were for plant and machinery, with £59bn of allowances claimed in 1999–2000.

[3] For comparison, the amount of income chargeable to corporation tax, following all allowances and deductions, was £130bn in 1999–2000.

Table 4. Capital allowances by asset type, 1999–2000

Type of asset	*Capital allowance*	
	Amount (£bn)	Percentage
Plant and machinery	59.0	91%
Industrial buildings	2.4	4%
Other assets	3.5	5%
All assets	64.9	100%

Source: Inland Revenue Statistics.

The importance of capital allowances also varies by business sector. Table 5 breaks down the amount of allowances claimed by sector. To give some idea of the scale of each industry, at least in terms of taxation, the table also shows the proportion of tax revenue arising from each sector. Allowances are relatively more important for the transport/communications and energy/water supply sectors. In contrast, while a third of tax revenue comes from the banking sector, only 17% of capital allowances arise in this sector.

Table 5. Capital allowances by business sector, 1999–2000

Business sector	*Capital allowances (% of total)*	*Tax revenue (% of total)*
Banking, finance and insurance	17%	33%
Business services	10%	14%
Distribution and repairs	10%	12%
Other manufacturing	8%	8%
Energy and water supply	15%	7%
Metal goods and engineering	9%	7%
Transport and communications	13%	5%
Extraction, metal manufacturing and chemicals	6%	4%
Construction	2%	3%
Hotels and catering	2%	2%
Agriculture, forestry and fishing	1%	0%
Other	6%	5%
All industries	100%	100%

Source: Inland Revenue Statistics.

As discussed in Section 2.3, accounts depreciation rates vary widely by industry. Given the variation in both accounts depreciation and the importance of capital allowances, any move from capital allowances to accounts depreciation will clearly lead to a significant redistribution of tax payments across industries. The evidence additionally suggests that depreciation rates

may, on average, be below the 25% writing-down rate of capital allowances available for plant and machinery.

Table 6 presents an international comparison of the value of capital allowances.[4] This shows that the existing capital allowances in the UK are broadly in line with provisions in other countries. In fact, the UK measure for plant and machinery is almost identical to the (unweighted) average across the countries presented. For industrial buildings, the average across all countries is about four percentage points higher than the UK measure, suggesting that other countries give more generous allowances for investments in this asset. There is, however, great variation for this asset – the USA has the lowest capital allowances, at 34.1%, while Greece offers the highest, at 76.4%.

Table 6. The value of capital allowances or similar provisions by country, 2001

	Plant and machinery	*Industrial buildings*
Austria	80.4%	50.9%
Belgium	86.1%	65.9%
Canada	81.9%	34.3%
Finland	82.3%	51.2%
France	88.7%	58.4%
Germany	82.8%	40.7%
Greece	80.1%	76.4%
Ireland	78.9%	42.2%
Italy	85.8%	54.2%
Japan	86.5%	56.0%
Netherlands	80.0%	51.1%
Portugal	84.6%	49.8%
Spain	76.4%	67.7%
Sweden	86.9%	57.1%
UK	**83.1%**	**48.7%**
USA	86.2%	34.1%
Average	83.2%	52.4%

Notes: Authors' calculations based on an assumed real discount rate of 5%. Inflation is the actual inflation prevailing in country and year. The average is the unweighted mean of the countries presented. For further details on specific calculations, see L. Chennells and R. Griffith, *Taxing Profits in a Changing World*, IFS, London, 1997.

[4] This measure gives the present discounted value of capital allowances. This takes account of whether straight-line or declining-balance depreciation is used and includes all first-year and initial allowances. The measure equals 0% for assets that have no capital allowances; it will equal 100% for assets that can be fully depreciated in their first year of use. Multiplying this measure by the tax rate gives the cash value of allowances to a company. To allow international comparisons, we present the measure prior to this multiplication, as otherwise countries with high tax rates would appear to have more generous allowances. For further details of this measure, see M. P. Devereux, R. Griffith and A. Klemm, 'Corporate income tax reforms and international tax competition', *Economic Policy*, 2002, vol. 17, pp. 451–95.

For comparison, if we used the average accounting depreciation rates prevailing in the 1970s and 1980s, as documented in Table 3, the value of the UK's capital allowances would be substantially lower than those in other countries. The likely increase in depreciation rates over the 1990s means that the impact of a move to accounts would be smaller, but such a move would still probably cause the UK to have one of the least generous systems for allowing depreciation on plant and machinery.

Given that the existing system of capital allowances eventually gives relief for all falls in value of allowable assets, the benefit or cost of any change will mainly be through a timing effect. The longer it takes a firm to write down an asset, the less valuable are all allowances over the lifetime of an asset in present-value terms. Note, however, that for most public companies, which will usually set up a deferred tax provision to reflect any timing differences, there may be no effect on their reported accounting profits.

Capital allowances are rigid and, furthermore, often intentionally different, e.g. the 100% allowances for computers purchased by small businesses are aimed at encouraging investment in new technology by small enterprises. Depreciation rates in accounts provide greater flexibility to reflect the true rate at which assets depreciate. But such flexibility may pose its own problems. Increasing the rate of depreciation recorded in the accounts could be used to defer tax. This would make accounts less accurate as a result. This might be a particular problem in smaller firms where there are no outside owners.

iii. Taxing gains on assets as recorded in accounts

Currently, gains made on the sale of assets are taxed under separate rules from other income. They are generally taxable when the gain is realised, but this charge is often deferred if the proceeds are reinvested. A move to an accounts-based system raises two major issues that need to be considered – the timing of the tax charge and whether purely nominal gains should be taxed.

On timing, the key question is whether gains should be taxed on a realisation or an accruals basis. Economic income would include gains as they accrue, regardless of whether they are realised or not. In practice, tax charges have generally only been levied on realised gains. This is because of the substantial compliance difficulties in valuing an asset unless it is sold (particularly in relation to intangible and illiquid assets) and the practical objections to seeking to raise tax when, without a sale, there will be no cash flow with which to make the tax payment.[5]

[5] In theory, firms could borrow against unrealised gains to pay a tax charge. But this depends on a perfectly functioning capital market and would add considerable risks to company cash flows.

Increasingly, accounting standards are moving towards accruals recognition of movement in the value of assets. If the government wishes taxation to follow accounts, then this would imply an increasing degree of taxation on accruals. This would effectively lead to a tax increase for appreciating assets, as it would bring forward the amount of tax paid. However, accounts have no cash-flow implications, whereas taxation clearly does. The factors driving changes in accounting standards may not be the same as those that should drive the tax rules.[6]

The government could introduce special rules to retain taxation on realisation. This raises the usual problem with taxation on realisation – namely, that it can produce a 'lock-in' effect, with the sale of an asset being discouraged as this will trigger a tax payment. For assets that are used in production, distortion of the timing of transactions can result in the use of inefficient production processes. To overcome this potential distortion, tax systems can employ rollover or reinvestment reliefs that defer the tax charge if part or all of the proceeds are reinvested. In practical terms, a deferral system is close to an exemption for any continuing business, given that its stock of capital assets is almost certainly going to grow in nominal terms over time, so that it will be able to defer gains indefinitely through continuing reinvestment.

Purely nominal gains on assets are currently exempt from tax via indexation relief. This is an unusual feature of the tax system, as nominal gains form the basis of taxation in virtually all other areas of the system. Under the proposals, these gains would be taxed. Given that inflation rates have fallen sharply over the last decade, the forward-looking impact of this change may be small. There could be a larger impact for existing assets unless they are protected under transitional rules.

2.5 Conclusions

There is clearly a need for further empirical work, but it seems likely that a move to accounts depreciation for plant and machinery could reduce the average rate at which capital expenditure is written off against tax. One implication would be that allowances, which are currently in line with international practice, would become less generous than elsewhere. The reform would certainly lead to a substantial redistribution of tax payments across industries. Whether or not there would be a large effect on investment is a debatable issue, which will clearly have to be considered as the consultation proceeds.

[6] It should also be noted that accounting standards are not fixed, but evolve over time. From 2005, the setting of these standards will be performed by the International Accounting Standards Board. This body will be charged with setting accounting standards without regard to the effect on the tax liabilities of UK companies.

The move from capital allowances would be a major change to the UK's tax system, so the fact that it would have substantial consequences is not surprising. This does not, in itself, mean that the reform would not be beneficial, but there need to be clear advantages to justify such adjustments.

For assets where there is currently no relief for depreciation, there is a clear case for the tax system to recognise this genuine economic cost. However, if capital allowances are retained on other assets, the consultation could consider, as an alternative to the current proposals, simply extending them to cover currently excluded assets.

3. The tax treatment of losses

The second major issue considered in the consultation is the treatment of losses. In this section, we outline the current treatment, discuss the various issues involved in quantifying the revenue effects of any change and raise some wider points that should be considered, either as part of this consultation or elsewhere.

3.1 The current system

It is an inherent feature of a tax system that collects tax on profits but does not provide full relief for losses (i.e. does not pay out an equivalent 'negative tax' on negative profits) that provision needs to be made to allow unrelieved losses to be carried forward and offset against past or future profits if manifest inequity is to be avoided. Two consequences flow from this:

i. Taxable income must always diverge from accounts profits when losses arise. There need to be tax rules governing how losses can be offset against profits of other periods.

ii. There may be some restrictions on the 'sale' of losses between economically unconnected companies if the tax yield is not to be significantly undermined.

The schedular system governs how losses can be offset against profits of other periods within a company. The consultation document proposes the relaxation or even the abolition of this system. Annex B summarises the schedular system, along with the main restrictions this places on the offset of losses.

The group relief system allows losses from one company to be offset against profits in another company in the same group. Group relief only applies to profits and losses that occur in the same accounting period. So losses cannot be carried forward against future profits of other companies in the group. The restrictions on group relief broadly reflect the current restrictions on losses within a stand-alone company, so that a business can achieve, in broad terms, the same overall tax treatment whether it operates as a single entity or as a group.

Relaxation of the schedular system could potentially result in a more favourable tax treatment of stand-alone companies compared with groups. If the balance struck by the tax system between the two is wrong, groups will face a tax-driven incentive to adopt a company structure that does not reflect their commercial needs. As a consequence, changes to group relief may be needed to re-establish balance in the event of schedular reform.

The second point identified above is the sale of losses. The UK tax system contains a number of restrictions on the sale of tax losses based on the existing rules for offsetting losses. These rules will need to be reviewed if a more liberal regime is introduced. They could be based on the premiss that all loss selling should be prohibited, though this approach might be hard to reconcile with the existing rules that allow extensive 'sale' of tax losses through the use of finance leasing, whereby asset ownership for tax purposes (and hence tax depreciation) can be transferred to a third party unconnected to the 'real' owner of the asset.

3.2 Quantifying the amount of losses

According to Inland Revenue figures, £80bn of losses were generated by UK companies in 2000–01. The majority of these, around £65bn, were offset against other profits in that year, presumably mainly under the group relief rules. This leaves around £15bn of unrelieved profits carried forward. Since both the schedular system and the group relief system allow a large degree of flexibility to offset losses against profits that occur in the same accounting period, it seems probable that the majority of the unrelieved losses occurred in companies and groups that are loss-making overall.

The consultation proposals involve relaxing the schedular rules, so that losses can be offset against income from a wider range of sources. There are a number of possible changes and the exact effects could vary greatly. To give a feel for the issues, we consider two key possibilities:

- *Allow Schedule D Case I and Schedule A losses to be carried forward against any Schedule D Case I and Schedule A income*. This relaxation of the Case I and Schedule A rules would allow losses to be carried forward and offset against profits from any trade within a company. The direct cost of this measure is likely to be small, as there are currently few companies with two separate trades. More substantive costs could arise from knock-on effects of the change. If there were no equivalent relaxation of the group relief rules, such a change would create an incentive to reorganise group structures so that profitable and loss-generating trades were held in the same company. The extent to which such a change might allow the effective sale of losses between economically unconnected companies (and hence revenue loss) is likely to be a further concern for government.

- *Allow losses from all sources to be carried forward against any future profits.* The major additional relaxation under this proposal is that trading losses could now be carried forward and offset against Case III interest income and capital gains, and vice versa. This is likely to have more substantive direct costs, as even companies with only one trade may also have some Case III activities. In addition, this proposal could have knock-on costs, as there would be likely to be opportunities to 'buy in' profits to use up trading losses and, without other legislative changes, increased opportunities to sell tax losses.

In both cases, the costing can be split between the direct costs of relaxation if business structures remained the same and the indirect costs resulting from behavioural change and loss selling. Depending on the proposals adopted, the balance between the two costs will vary. But it is likely to be desirable to minimise the indirect costs, either by explicit rules to prevent particular behaviour or by explicitly freeing up group relief and/or the loss-selling rules at the same time.

There is also a distinction between the transitional and long-run costs of any reform. Moving to a new regime will involve a one-off acceleration in the rate at which losses can be used. The transitional cost will depend on how the existing stock of losses is integrated with the new regime. For the public finances, it is the long-run cost that should be most relevant.

3.3 International issues and enterprise incentives

In addition to the issues flowing directly from the proposals discussed above, there are two other issues that require consideration:

- For multinationals, losses arising in an overseas subsidiary are not allowable against profits arising in the UK.

- For a stand-alone company with solely trading activity, losses can only be offset against profits in the immediately preceding accounting period or in any future accounting period.

So long as the corporation tax system is based on the company as the taxable unit (rather than the consolidated worldwide group), governments are unlikely to address the first of these issues and to allow relief for losses that arise in overseas jurisdictions. However, there may be a case for allowing immediate relief for losses arising in stand-alone companies, especially in their start-up phase. Indeed, the R&D tax credit for small and medium-sized companies introduced in April 2000 allows precisely this, in that the government will pay directly to firms any part of this credit that would otherwise be unused.

There is some recent evidence from the USA that loss relief in general is important for the stimulation of enterprise.[7] The easiest way to think about this is that the government becomes a silent partner – taking a share of the gain if the enterprise succeeds, but also, through relief for losses, taking a share of the pain if the enterprise fails. The greater the restriction on loss relief, the more the tax system biases investment towards less risky projects. These wider issues should be considered, either as part of this consultation or elsewhere.

4. Conclusions

One of the government's key aims is to simplify the current tax system. Accounts provide a pre-existing mechanism for measuring a company's income, and fully aligning tax and accounts would clearly reduce the computational requirements for assessing tax. Accounts also provide greater flexibility to accommodate the realities of individual businesses than, say, legislatively prescribed capital allowances.

But it is not clear that taxation should always follow accounting practice. In regard to the taxation of assets, the government has made clear that it wishes to retain the existing specific investment incentives for a number of assets and companies. It is far from clear that the tax system should follow accounts in recognising unrealised gains. Also, the government has given a commitment to examine special cases for individual industries and types of assets. The consultation needs to consider whether, in these circumstances, any real simplifications can be achieved. Any system that does not follow the accounts very closely is unlikely to generate significant compliance savings.

On losses, the consultation provides a welcome opportunity to assess whether to retain the many arcane restrictions on how losses can be offset against other sources of income. Going forward, the key considerations in developing firm proposals will be whether the cost to the exchequer is proportionate to the likely beneficial effects and that any new system maintains a workable balance between the taxation of groups and companies. There is also a case for considering, either as part of this consultation or elsewhere, whether other forms of loss relief, such as for start-up companies, might offer economic benefits.

[7] For example, see R. H. Gordon and J. B. Cullen, 'Taxes and entrepreneurial activity: theory and evidence for the US', NBER Working Paper no. W9015, 2002.

Annex A: The current tax treatment of capital assets

This annex explains the terms used in Table 1 in the main text.

Declining-balance method

This is a method for calculating capital allowances. The allowance is a fixed percentage of the tax written-down value (i.e. the original cost less any capital allowances already granted). So for an asset that cost £100, assuming a 25% rate, the allowance in the first year would be £25 (£100 × 25%). The tax written-down value for the second year would be £75 (£100 – £25) and the allowance would be £18.75 (£75 × 25%). The tax written-down value for the third year would be £56.25 (£75 – £18.75) and the allowance would be £14.06 (£56.25 × 25%). And so on.

Straight-line method

This is a method for calculating capital allowances. The allowance is a fixed percentage of the original cost. So for an asset that cost £100, assuming a 4% rate, the allowance in *each* year would be £4 (£100 × 4%). After 25 years, the value of the asset would be fully depreciated.

Pooled plant and machinery

Most plant and machinery is depreciated in a 'pool', which effectively creates a single, aggregated asset for which capital allowances can be calculated. The cost of purchasing new assets is added to the pool and the proceeds from selling old assets are subtracted. Declining-balance capital allowances are calculated for the balance in the pool.

Clawback and losses (relative to tax written-down value) for pooled assets

When an asset is sold, the pool effectively 'smooths' both the clawback of excess allowances and the relief given for any loss. These clawbacks and loss reliefs effectively occur at the declining-balance rate.

Rollover reliefs

When a qualifying asset is sold at a profit, the tax on the gain can be deferred if the proceeds are reinvested in another qualifying asset. The new asset must be purchased up to either one year before or three years after the disposal of the old asset.

Annex B: The schedular system and losses

The schedular system evolved within the UK income tax system in the nineteenth century and was integrated into the UK's corporation tax system as it was developed in the 1960s. Under the system, income from different sources is divided into separate schedules and cases. The main ones are set out in Table 7.

Table 7. The schedular system of classifying income

Schedule	*Case*	*Description*
A		**Property income**
B (abolished)		Woodlands
C (abolished)		Paying and collecting agents
D	**I**	**Profits and gains of trades**
	II	Profits and gains of professions or vocations (effectively Case I)
	III	**Interest receivable (now covered by the loan relationship rules)**
	IV	Income from overseas securities (abolished for companies)
	V	**Income from overseas possessions**
	VI	Miscellaneous income
E		Emoluments
F		Dividends from UK companies (not taxable when received by another UK company)

Note: Bold type signifies schedules and cases that are important for business taxation purposes.

Each case has different rules applicable to the computation of income (and the allowability of expenses). Although these have been significantly aligned in recent years, not least by subsuming interest payments and receipts to accounts treatment, some differences do remain. The schedular system categorises income. In addition, capital gains and losses also have their own rules.

The main restrictions on use of losses produced by the schedular system are set out below.

Schedule D Case I losses

– These losses can be relieved against

  - total profit in the accounting period producing the loss;
  - total profits of the 12 months preceding the loss-making accounting period;[8]
  - trading profits of the same trade in any future accounting period.

– Losses carried forward must be used against the first available trading profits.

– Relief must be claimed for the period producing the loss before it can be carried back to previous losses.

[8] Note that terminal loss relief is allowable against profits arising in the previous *three* years.

Schedule D Case III losses

– Losses on loan transactions are now dealt with as part of trading losses if the loans arise in the course of a trade.

– In other cases, losses (i.e. excess interest expense) can be used against other profits of the same period and the previous period (as for trading losses) or carried forward against future non-trading profits or capital gains in the same company.

Schedule A losses

– These losses arise fairly infrequently. They can be

  - offset against any other income and chargeable gains in the current accounting period;

  - carried forward against any future income and chargeable gains as long as Schedule A activity continues.

Capital losses

– These losses can be offset against capital gains only.

– Losses can be carried forward to offset against future capital gains.