Further written evidence submitted by the Chartered Institute of Taxation (clauses 19-32 and related schedules) (FB18)

Representation from the Chartered Institute of Taxation for Public Bill Committee considering Finance (No 2) Bill 2017-19

Corporation Tax, etc
(clauses 19-32 and related schedules)

Executive Summary

Research and development expenditure credit (clause 19)
Good news for large businesses, but is there more government could do to help large and small businesses alike to access R&D support? We think so.

Intangible Fixed Assets (clauses 20 and 21)
If there are concerns about perceived avoidance, these should be dealt with under separate, properly targeted, anti-avoidance rules. The intangibles regime is now more complicated than ever and should be reviewed with a view to simplifying it.

Hybrid and other mismatches (clause 23 and schedule 7)
We appreciate the need for these rules, but they are complex and have unintended consequences.

Corporate interest restriction (clause 24 and schedule 8)
Welcome, but only necessary because of flaws in the legislative process when the regime in this area was introduced.

Freezing of indexation allowance for gains chargeable to corporation tax (clause 26)
We welcome this measure as a simplification and a modest step toward aligning tax and accounts.

Depreciatory transactions within a group of companies (clause 28)
This measure appears to place a significant additional compliance burden on companies with very little justification.

Double taxation arrangements specified by Order in Council (clause 32)
This is a sensible measure supporting the OECD-led Base Erosion and Profit Shifting process. The BEPS initiative is achieving considerable success and governments should beware unilateral actions which might undermine this.

1. Research and development expenditure credit (clause 19)

1.1 This clause increases the rate of the Research and Development Expenditure Credit (RDEC) from 11 per cent to 12 per cent, for expenditure incurred on or after Jan 1st 2018.

1.2 The main beneficiaries of this more generous credit will be larger companies rather than SMEs. This is because government support for R&D is provided through two separate regimes – one (RDEC) primarily for large companies and one for SMEs. However the change will also benefit those SMEs with subsidised expenditure or undertaking R&D subcontracted to them by a large company, as they will claim RDEC on that expenditure.

1.3 There has been some criticism that the large company regime has been made more generous but not the regime for SMEs. However it should be noted that the SME relief is already relatively generous. There are other ways, though, that the government could help small as well as large businesses to access R&D support (see below).

Advanced Clearance Service (ACS)

1.4 Alongside the announcement of the rate rise at the Autumn 2017 Budget, it was announced (Overview of Tax Legislation and Rates (OOTLAR), paragraph 2.24) that 'the government will pilot a new Advanced Clearance service for Research and Development (R&D) expenditure credit claims, to provide pre-filing agreement for 3 years'. This looks to be delivering on a promise made in the Spring 2017 Budget to 'make administrative changes to the Research and Development Expenditure Credit to increase the certainty and simplicity around claims'. This sounds promising, and anything that helps more companies claim R&D relief is to be welcomed; however it lacks detail and prompts a number of questions, which could be usefully raised by the committee during discussion on this area.

1.5 First, how does HMRC intend to resource the ACS? R&D specialists within HMRC are already spread very thinly on the ground. An application for clearance will require their attention, presumably within a specified time frame. Is that going to mean resources are diverted from dealing with other claims? If the scheme is successful there might be fewer claims that need reviewing in the normal course of events (as they will have been 'pre approved'). However the number of R&D claims is increasing each year and, presumably, not all claims will be suitable for approval through the ACS. Will the government consider increasing the number of R&D specialists at HMRC?

1.6 Second, R&D projects, by their very nature, have a significant element of uncertainty. Whilst it may be possible at the outset to scope out a plan, in reality it probably won't be long before the plan has to be revised in real time as challenges materialise. How far can the R&D plan change before the clearance needs to be revisited?

1.7 Third, why is this being restricted to RDEC? Do the government think large companies need greater certainty than SMEs? Is there a plan to roll it out to all companies if the pilot is successful?

1.8 We acknowledge that there is already an Advance Assurance scheme available for very small first time claimants of R&D relief. This was launched in November 2015 and enables very small first time claimants to have their R&D claims 'pre-approved' for three years. For small companies, particularly start-ups, this is a big benefit. Nevertheless it applies only in very limited circumstances and does not cover most SME R&D claims.

R&D credit awareness

1.9 The government have also promised to launch a campaign to increase awareness of eligibility for R&D tax credits amongst SMEs. We are told that the government will work with businesses that develop and use 'key emerging technologies' to ensure that there are no barriers to them claiming R&D tax credits. This is welcome. CIOT has long called for greater efforts to promote R&D relief and encourage uptake among SMEs in particular. Many SMEs continue to labour under the misapprehension that R&D credits are only available for 'white coat' scientific research when in reality they are much more widely available than this.

1.10 The government should also consider handing responsibility for promoting R&D relief to UK Research & Innovation. HMRC does its best to promote the relief but the reality is that smaller companies in particular are wary of HMRC and this hampers their efforts.

R&D at commercialisation stage

1.11 The government should consider extending R&D relief into product commercialisation. The Prime Minister and Chancellor have both referred to the fact that the UK is good at generating inventions but those inventions tend to get commercialised abroad. Relaxing some of the recent restrictions on R&D in this "commercialisation" phase – what HMRC refers to as "production" – could be one way of addressing this, alongside measures to increase financing available for innovation (patient capital).

1.12 While the patent box provides an incentive to commercialise R&D in the UK, not all successful R&D will result in a patent - patents are costly and the process is time consuming.

2. Intangible Fixed Assets (clauses 20 and 21)

2.1 These two clauses are related measures aimed at counteracting tax avoidance based on exploiting, within the same corporate group, the differences between the accounting treatments that have to be adopted by a licensor and a licensee of intangibles.

2.2 Inevitably, addressing this issue involves overriding the accounting treatment and introducing additional complexity to the rules. There are other examples of this approach in the intangibles code (and other parts of the tax code that are largely accounts-based, for example, loan relationships rules), and generally these have worked well.

2.3 However, the intangibles regime is, as a result, now more complicated than ever and this creates uncertainty for taxpayers. We therefore support the Office of Tax Simplification's recommendation that this regime should be reviewed, and we have made representations to the government encouraging them to do this.

2.4 The current regime was introduced in 2002 and gives relief for expenditure on intangible fixed assets written off over time (amortised) to profit and loss account, and taxes income and other credits arising from such intangible assets. However, the regime does not apply to pre-2002 assets so an intangible asset that existed before 2002 only qualifies for relief under the capital gains tax regime, whereas intangibles (including until 2015, acquired goodwill) from 2002 do qualify, resulting in a two-tier system.

2.5 The rules were further complicated by legislation in Finance (No 2) Act 2015 which denies a deduction for goodwill and related relevant assets acquired on or after July 2015, other than debits or credits arising on realisation of the asset. The result is a three-tier scheme for goodwill depending on whether it was acquired before 2002, or relates to a business that has been carried on since before that date, was acquired between 2002 and 2015 or after 2015. This seems to us to be unnecessarily complicated.

2.6 We have a number of specific proposals we would like the government to consider. These include:

- reinstating the deduction for acquired goodwill (and goodwill-like assets). If the government believes that this relief was subject to abuse, we would suggest targeted anti-abuse measures are preferable to no relief at all;

- mandating that the tax treatment for all taxpayers should follow the treatment required by UK accounting standard FRS102 (generally currently used by smaller companies) which requires amortisation of goodwill over its useful life, subject to the existing 4% election; and

- abolishing the distinction between pre-2002 and post-2002 intangibles for all future transactions. The argument for alignment is strengthened by the complication that goodwill generated in a business after 1 April 2002 is deemed to be a pre-2002 asset as long as the business was carried on at 1 April 2002 by the company or a related party; the longer the elapse of time since this date, the more likely it is that uncertainty will arise as to whether the business was being carried out at that point, or whether the business has changed so much it must be regarded as a different business. The question of what comprises a business is also unclear and is a potential source of dispute.

2.7 In short, we would like to support the recommendations made by the OTS in their recent report on the simplification of the corporation tax computation in relation to goodwill and related relevant assets (paragraphs 5.59 – 5.62). We also agree with the OTS' recommendation that, if there are concerns about perceived avoidance, these should be dealt with under separate, properly targeted, anti-avoidance rules.

2.8 In addition, we have suggested that the Chancellor considers extending to intangible fixed assets within Part 8 CTA 2009 the exemption from a de-grouping charge when there is a deemed disposal of an asset held by a company upon the disposal of the company and the corporate disposal qualifies for SSE. The general rule is that if an asset is transferred from one group company to another group company, this occurs on a no gain/no loss basis for tax purposes and no charge to tax arises. However if the transferee company leaves the group within six years of the intra-group transfer, there is a deemed disposal and there is a charge to tax on any gain that arises (the de-grouping charge). In 2011 an exemption was introduced for capital assets within the charge to corporation tax on capital gains if the share disposal qualifies for SSE, but was not extended to intangible fixed assets, which were subject to similar rules and a de-grouping charge under the intangible fixed assets regime. We have suggested that the two regimes should be aligned to address the imbalance in treatment.

2.9 As well as simplifying the regime, we consider that the changes suggested above would help make the UK a more attractive place to do business. This is a timely moment to make these changes, as multinational companies are considering their group structures in light of the output of the BEPS Action Plan and are also reflecting on the impact of the UK exiting the EU. We recognise that the ability to claim relief for goodwill and related relevant assets (other than on realisation) was only removed recently, through legislation in Finance (No 2) Act 2015. However, this legislation was implemented well before the EU referendum, when contemplation of the specific challenges arising from Brexit was not on the horizon. In addition, recent US tax reform makes the intangible assets regime an issue to address with some urgency.

2.10 Accordingly, we welcome the announcement at the Autumn Budget 2017 (Overview of Tax Legislation and Rates (OOTLAR), paragraph 2.31) that the government will consult in 2018 on the intangible assets regime. We look forward to engaging with this consultation and hope that it will encompass the points above.

3. Hybrid and other mismatches (clause 23 and schedule 7)

3.1 The current hybrid and other mismatches regime was introduced by Finance Act 2016. The purpose of the regime is to prevent multinational companies taking advantage of differences between laws in different countries to artificially reduce their tax bill using techniques such as claiming the same deduction twice. The regime reflects the recommendations of the G20/OECD project to tackle Base Erosion and Profit Shifting (BEPS).

3.2 This clause and schedule make a number of detailed changes to the rules in this area, primarily attempting to clarify the operation of these rules.

3.3 Most of the changes will have retrospective effect from the start of January 2017, the original commencement date for the Finance Act 2016 legislation. Retrospective legislation is generally something to be avoided and arises in this context due to the complexity of the rules: the changes aim to add additional clarity to the regime.

3.4 We fully appreciate the need for these rules, but they are very complex and have some unintended consequences. It is still unclear how they will operate in some commercial circumstances where no avoidance is present (for example in relation to a UK trading company that is 'checked' for US tax purposes). We continue to encourage HMRC to work closely with stakeholders on these matters.

4. Corporate interest restriction (clause 24 and schedule 8)

4.1 We welcome the amendments made by schedule 8 but feel they are only necessary because of flaws in the legislative process when the regime in this area was introduced.

4.2 The corporate interest restriction rules were introduced in Finance (No.2) Act 2017 – the Act which gained Royal Assent on November 16th 2017 – with retrospective effect from April 1st 2017. The rules restrict the amount of interest and other financing amounts that a company may deduct in computing its profits for the purposes of corporation tax. All groups are able to deduct up to a £2m de minimis amount. After this amount, net interest expense is restricted to 30% of taxable profits before interest, tax, depreciation and amortisation (tax-EBITDA), or the group ratio percentage (based on the ratio of accounting net interest expense to accounting EBITDA) of tax-EBITDA if that is higher and a group elects to use it. Both ratios are limited by a modified debt cap to the group's aggregate net interest expense of the period. The introduction of the regime was significantly revenue-raising. The government expects to raise just under £4 billion from it over its first four years.

4.3 The amendments in the current Bill include both technical amendments to correct anomalies in the original legislation and limited policy changes.

4.4 The CIOT criticised the original legislation for being rushed. The new rules are extremely complex and the late publication of what was intended to be the final legislation in Finance (No2) Bill 2017 in March (as a result of the short timetable) meant there was a tremendous amount for taxpayers and advisers to digest before the commencement of the rules in April.

This was then followed by the removal of these provisions from the pre-election Finance Bill, which caused more uncertainty. Although the delay in enacting the legislation allowed for a period of further informal consultation which improved the legislation in some respects, the legislation remained flawed, hence the amendments in this Bill.

5. Freezing of indexation allowance for gains chargeable to corporation tax (clause 26)

5.1 As announced at Autumn Budget 2017, this provision freezes indexation allowance on corporate capital gains for disposals on and after 1 January 2018. The allowance for subsequent disposals will be frozen at the amount that would be due based on the Retail Price Index for December 2017.

5.2 The measure is believed by the Treasury to be a significant revenue raiser, with the government estimating that it will raise £30m for 2017-18 rising to £525m for 2022-23.

5.3 Freezing the indexation allowance in this way does, to a large extent, address an anomaly in the taxation of capital gains as between companies and individuals, which is a stated government policy objective. Indexation allowance for individuals and non-incorporated businesses (who pay capital gains tax) was abolished in 2008.

5.4 We welcome this measure as a simplification and a modest step toward aligning tax and accounts.

5.5 The change does mean that there is tax on the inflationary element of gains on capital assets: indexation allowance is effectively a form of relief from capital gains tax on inflation. However, the tax system taxes the inflationary element of gains on other things for companies, such as the growth in value of trading stock and, of course, the inflationary element of capital gains for individuals since 2008.

6. Depreciatory transactions within a group of companies (clause 28)

6.1 This measure removes the time limit of six years for which a company must look back and adjust the capital loss claimed on sale of shares in a subsidiary company to account for earlier depreciatory transactions that have materially reduced the value of those shares.

6.2 When a company sells shares in another company (the ‘target’), the taxable proceeds might have been reduced by previous transactions within the same group of companies which have, for example, moved valuable assets out of the target company’s ownership at an accounting value which is lower than the market value (‘depreciatory transactions’). These can be either innocent (groups of companies have frequent commercial reorganisations) or tax-motivated.

6.3 The current rules require all records to be kept and adjustments to be made to neutralise the effects of all ‘depreciatory transactions’ within six years prior to the disposal. It is now proposed to remove this six year limit. This will require all groups of companies to keep much more burdensome and extensive records, just to compute the gains properly and comply with the rules.

6.4 We are very sceptical of the view that tax-motivated transactions of this nature would occur on a material scale more than six years ahead of a taxable disposal. We are not aware of any evidence that this has been happening. The government’s impact note claims that the measure will protect £10 million of revenue a year but does not indicate how this figure has been calculated.

6.5 In short, this measure appears to us to place a significant additional compliance burden on companies with very little justification.

6.6 The measure is also particularly surprising given that the time limit of six years was only introduced in Finance Act 2011, to ease the compliance burden. The six year limit was introduced in conjunction with the new value shifting rules, as it was felt by the government at the time that the new motive based value shifting rule on the disposal of shares and securities would adequately counteract deliberate value shifting arrangements, such that the previous depreciatory transaction adjustment going back potentially to 31 March 1982 was no longer necessary.

6.7 It is also difficult to see why the government considers this to be a significant problem, bearing in mind that (i) the substantial shareholding exemption will negate most capital losses on share disposals (especially following the F(No 2)A 2017 changes) and (ii) the value shifting rule in TCGA section 31 introduced by Finance Act 2011 should counteract any deliberate planning.

6.8 This leaves, therefore, a small number of non-tax motivated disposals where, when calculating a capital loss, it will now be necessary to examine every asset transfer/transaction going back to 31 March 1982 to confirm whether these were made at market value. This seems an excessive and unnecessary compliance burden on these taxpayers.

7. Double taxation arrangements specified by Order in Council (clause 32)

7.1 This clause ensures the UK can implement the Multilateral Instrument (MLI) that has come out of the OECD/G20 Base Erosion and Profit Shifting (BEPS) process. The MLI enables countries to amend *en masse* the more than 1,100 bilateral double taxation treaties currently in effect, without needing separate negotiations for each one. (Double taxation treaties try to make sure that people and companies do not pay tax twice on the same income.)

7.2 We agree with the government that it was questionable whether existing powers in the Taxation (International and other Provisions) Act 2010 were sufficient to implement the MLI. Double tax treaties need to be given effect in UK law and the pieces of legislation amended by clause 32 are some of the main provisions of law which do that. They do so by giving effect to agreements made (mainly) to reduce double taxation. The first agreement with any country clearly will reduce double taxation and is within the ambit of this formulation. But if then the double tax agreement with that country is amended so as to restrict or modify the earlier provisions, for example to make them less vulnerable to tax avoidance, it could be argued that such an amending agreement is not itself intended to reduce double taxation and so isn’t given effect by provisions that use that type of formulation. It is therefore sensible of the government to introduce these changes to put the matter beyond doubt.

7.3 The OECD-led BEPS process (in which the UK played a very active role) aims to move the international tax system (which is essentially a product of many negotiated agreements) on an agreed multilateral basis closer toward operating on the principle that profits of multinational businesses are taxed where they are earned, and to close down opportunities to avoid taxation altogether, while retaining protection from double tax for genuine cross border business.

7.4 Overall our view is that this process has achieved considerable success in achieving agreement on a realistic set of actions and that priority should be given to implementing these effectively at individual country level.

7.5 The danger of a series of unilateral steps by countries or blocs like the EU, outwith this international process, is that the degree of consensus that has been built on allocating profits internationally will be thrown into reverse, and countries and blocs will adopt increasingly different, rather than similar, approaches to taxation - this would likely create discriminatory double taxation as well as renewed opportunities for international arbitrage by the unscrupulous, because of the interaction of different regimes.

8. The Chartered Institute of Taxation

8.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

8.2 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

8.3 The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

10 *January* 2018