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The Related Companies Simplification Review Team
Room 2/E1
HM Treasury
1 Horse Guards Road
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22 February 2011

Dear Mr Donlan and Ms Shah

Comments on the Simplification Review: Capital Gains Rules for Groups of Companies

We are pleased to have the opportunity to comment on the draft legislation relating to the simplification of the capital gains rules for groups of companies as set out in the discussion document dated December 2010, and the related draft guidance published by HMRC in January 2011.

By way of background, the City of London Law Society ('CLLS') represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

1. **DEGROUPING CHARGES**

Legislation

1.1 The draft legislation proposes the repeal of section 179B TCGA 1992. While the proposed new degrouping rules mean that there will not normally be a gain to roll-

over under this section, the current degrouping rules continue to apply where a company leaves a group without a disposal of shares (which could arise as a result of the company issuing new shares). In these circumstances, section 179B could still be applicable, and we therefore see no reason for its repeal.

1.2 The proposed new section 179ZA(5) refers to any "associated company", and we note that this term is not defined. Section 179(10) will (following its proposed amendment) provide a definition of when companies are associated with each other, but this is expressed to apply only for the purposes of section 179. Should this definition also be expressed to apply for the purposes of section 179ZA?

HMRC Guidance

1.3 There are a number of references to "on or before [the date of Royal Assent]". These should be to "before [the date of Royal Assent]".

1.4 In CG45420:

(a) In the first bullet point, we make the observation that it is not correct to say that "this ensures that the benefit of the alternative mechanism applies equally to groups with an overseas holding structure", because the alternative mechanism only applies in the case of a disposal by a person outside the charge to corporation tax if the disposal would have been within the substantial shareholdings exemption if the person had been within that charge.

(b) In the fourth main paragraph, it might be helpful to amend the first sentence in the interests of clarity to say: "It is possible that a company A may leave a group as a result of more than one group company making a simultaneous disposal of company A shares or shares in another group company."

1.5 In CG45430:

(a) In the Example, it would be helpful to make it clear that when reference is made to the rise in the value of the asset and the fact that this will or will not be taxed when A is sold, that this is disregarding the potential effect of any degrouping charges that might apply.

(b) In general, we would like to see far more detailed guidance on when (and to what extent) it will be just and reasonable to adjust a gain under new section 179ZA. The guidance on this seems inadequate, given that in substance it only consists of the four line paragraph that begins "It is common practice..." This is particularly important given that taxpayers will need to self-assess the amount of any adjustment. We assume that the one example given in this paragraph is not the only case where HMRC envisage that there could be economic double taxation if a degrouping charge were to apply. In particular, there could be economic double taxation in cases where the relevant asset is transferred at a value that exceeds book value but is below market value.

We are of the view that it should at least be possible to say more generally that it will be just and reasonable to adjust a degrouping gain where the asset's increase in value during the period of its ownership by the group is already reflected in the gain accruing on the disposal of shares that triggers the degrouping charge (as you note specifically in relation to the case where the sub-group exception at new section 179(2) is unavailable because the transferor company is struck off before the remaining part of the sub-group leaves the group). Ideally, we would like to see detailed examples that are similar to those provided in the value shifting guidance referred to below.

2. **VALUE SHIFTING AND DEPRECIATORY TRANSACTIONS**

Legislation

2.1 In the proposed new section 31(3)(a), we consider that "at the time of the disposal" could be amended in the interests of clarity to "immediately before the time of the disposal".

Guidance

2.2 We welcome the attempt to set out in detailed guidance the situations in which the TAAR would apply, although the guidance is not as extensive as we would have hoped. In particular, we believe it would be more helpful to provide a "white list" and a "black list" of transaction types which HMRC consider to be legitimate tax planning on the one hand, and avoidance on the other. There are also several transaction types that we would have expected to be dealt with and are not - these include group relief surrenders for less than full consideration, transfer pricing corresponding adjustments and intra-group debt waivers.

2.3 In CG48530, there is no guidance on the meaning of "materially" in section 31(1)(a). Is the use of the word "materially" intended to import a de minimis threshold for the application of the rule? If so, it might be helpful to include HMRC's views on when a reduction in value is material for this purpose.

2.4 In CG48540, in the last paragraph, it would be helpful to set out in what circumstances HMRC consider that an adjustment will be required under section 31 where a target company enters into transactions in order to enable it to pay a pre-sale dividend. Example 5 in CG48560 makes it clear that borrowing to pay the dividend is unacceptable. But it is unclear whether carrying out a reduction of capital in order to pay a dividend would infringe the rule. Example 2 indicates that an adjustment under section 31 will arise where the vendor company subscribes for additional shares in order to increase its base cost in advance of the reduction in capital and payment of the dividend. In Example 7 there is no share subscription in advance of the reduction and this does not give rise to an adjustment, but this is seemingly because the target is being wound-up rather than sold out of the group (as referred to in CG48520). In Example 10, an adjustment is said to be required in similar circumstances, although this is seemingly because the arrangements mitigate an 'exchange gain' (on which see further below). It would therefore be helpful to set out HMRC's views on whether

an adjustment would be required if a target company carries out a reduction of capital (not preceded by a further share subscription) in order to pay a pre-sale dividend. We do not see why this should be objectionable, since otherwise a cash rich company would be penalised simply for having low distributable reserves.

2.5 In CG48560 (the examples), we suggest that this section might be split into two parts - examples in which HMRC considers it unlikely that a main purpose of obtaining a tax advantage will be present (comprising Examples 1, 6, 7, 8 and 9) and where such a purpose is likely to be present (Examples 2, 4, 5 and 10). We acknowledge that Example 3 does not fit easily into either category because it describes the impact of new section 31(5) on section 29 TCGA.

2.6 Generally, where figures are given in an example, it would be helpful to specify what the adjustment to the consideration might be under the just and reasonable test. For example, in Example 2 we assume that the consideration would be treated as increased by £900,000 to £1.9 million so that the vendor company still makes a gain of £900,000. We note that this example sits uneasily with the wording of the legislation, given that the tax advantage arises from increasing the base cost in the target shares rather than from reducing their value (which is £1 million both before and after the arrangements). Although in a way the value of the shares in the target is reduced with the payment of the dividend, this is not the effect of the arrangements as a whole, and we are not sure that the legislation as drafted applies in these circumstances. It would also be helpful to put figures to some of the examples that do not include them (e.g. Example 3).

2.7 In Example 3, in the second paragraph, it would be helpful to make clear that "the value reduction" refers to "the value reduction of the shares in Q pursuant to the 'drain out dividend scheme'". Presumably the reference to "the new company" should instead be to Q, as there is no new company in this example?

2.8 In Example 5, we are not sure it is accurate to describe the repayment of the loan as "effectively additional consideration" as the parent had to lend this money to the target to begin with, and obviously it would not be received by the parent had the target borrowed from another person (as is suggested). The real mischief here is that what would otherwise be a capital receipt is converted in part into a tax exempt dividend, which is the case regardless of the identity of the lender.

2.9 In Example 7, we assume that the reference to Example 2 should be to Example 5. The contrasting factor in Example 2 is that there is a further share subscription in advance of the reduction of capital.

2.10 In Example 8, while we agree that the proposed arrangements should not give rise to an adjustment under section 31, this conclusion does not sit well with the actual wording of the draft legislation. There would seem to be arrangements that achieve a reduction in the value of the shares in the target company, and these arrangements could be said to have a main purpose of achieving a tax advantage (which will be realised), assuming a purchaser would be prepared to buy the company with the cash balance. Section 31(1)(c) is restrictive and does not apply to transactions which have a similar economic effect to a

straightforward pre-sale dividend. We suggest that section 31(1)(c) is amended to address this possibility, or that section 31(2) is amended so that in determining what is a just and reasonable adjustment to the sale consideration it is permissible to take into account what reduction in the gain could have been obtained by making a pre-sale dividend.

2.11 The guidance suggests that the result has also been arrived at because "the sale consideration reflects the value of what has been sold." This is perhaps slightly misleading - presumably what is meant here is that the consideration reflects the value of the underlying assets in the target company whose value has not been artificially deflated through pre-sale borrowings to fund the capital contribution.

2.12 In Example 9, would it be more accurate to say that there has been a reduction in value of the target company but that this was not part of arrangements with a main purpose of obtaining a tax advantage?

2.13 It is not clear why Example 10 gives a different result to Example 7; in both cases a capital reduction is used to make a tax exempt distribution to avoid a chargeable gain arising on the winding-up of the target company. The guidance at CG48520 indicates that HMRC consider this to be acceptable. The only difference in Example 10 appears to be that what is mitigated is what is described as an 'exchange gain', although it is not entirely clear why this should make a difference to the result under section 31, and it would be helpful if the guidance provided some explanation for this.

3. CAPITAL LOSSES AFTER A CHANGE IN OWNERSHIP

Legislation

3.1 We approve of the relaxation of the rules on the use of pre-entry losses against gains on assets used in a continuing business (reflected by new sub-paragraph 7(1A) Schedule 7A TCGA 1992) such that a group will continue to be able to access such losses even if the same company does not carry on the business. It is a helpful simplification that an acquiring group will be able to transfer a business that it acquires to another group company without losing access to pre-entry losses of the acquired company.

Guidance

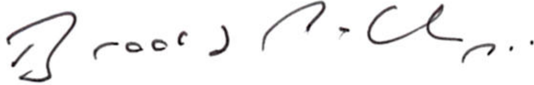
3.2 In relation to the draft guidance issued in this connection, we make only minor comments:

(a) In the guidance headed "Capital loss streaming from [date of Royal Assent]: pooled or merged assets", the reference to TCGA92/SCH7APARA7(2)(b) should be deleted as sub-paragraph (2) will be repealed by the draft legislation; and

(b) Generally, we note that references are made to "Case 1 profits" rather than "trading profits" and it would be preferable to bring these references up to date.

We trust that the above comments will be of assistance. As a Committee of experienced tax lawyers, we are very well placed to comment on the process relating to tax law making and we would be happy to meet with Treasury/HMRC to discuss this topic further.

Yours sincerely



BRADLEY PHILLIPS
Chair
City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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