



HM TREASURY



HM Revenue
& Customs

Simplification review:

**the associated company rules as they apply
to the small profits rate of corporation tax –
a summary of consultation responses**



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1

Introduction

1.1 In October 2009 the previous Government published the consultation: *Simplification review: the associated company rules as they apply to the small companies' rate of corporation tax*. The Government confirmed in the emergency Budget on 22 June 2010 that it will introduce the proposed reform in Finance Bill 2011, with the legislation taking effect from 1 April 2011.

1.2 This document summarises the responses received to the consultation and also reflects further discussions with interested parties. It also includes revised draft legislation and guidance shaped by those responses. Further comments on the legislation and guidance are welcome.

2

The consultation

Background to the review and consultation

2.1 Following the launch of the Related Companies Simplification Review at the 2007 Pre-Budget Report, the previous Government published an online survey on corporation tax rules for related companies to identify which areas of these rules were possible candidates for simplification. Over 140 responses were received from a range of interested parties, including professional tax advisers and representative groups. In December 2007, the previous Government issued an update on the review, outlining four areas identified as having potential for reform. One of these was the associated company rules as they apply to the small profits rate of corporation tax (SPR).¹

2.2 In the Finance Act 2008, the previous Government simplified the existing rules defining control of a company where a director or shareholder is separately in a partnership. However, this was only a first step in simplifying the rules, and discussions continued with representative bodies to identify how the rules could be further reformed. These discussions identified the main priority for reform as the rules governing control of a company through the attribution of rights held by one or more of their associates. A consultation document was published in October 2009 and can be found at http://www.hm-treasury.gov.uk/consult_simplification_review.htm.

Purpose of the consultation

2.3 Corporation tax was introduced in 1965 as an annual tax on the profits of companies. Initially, a single rate of corporation tax for a financial year applied to all companies irrespective of their level of taxable profits. Finance Act 1972 introduced a lower rate of corporation tax for companies with small profits. From 1 April 2010-11, the SPR is 21 per cent compared to the main rate of corporation tax of 28 per cent. The emergency Budget announced both rates will be reduced in future years: the SPR will fall to 20 per cent from 1 April 2011 and the main rate will be reduced to 24 per cent over 4 years from 1 April 2011.

2.4 The SPR applies to companies whose annual profit does not exceed £300,000 (the 'lower limit'). If a company's profits are above £300,000 but do not exceed £1.5 million (the 'upper limit') the main rate of corporation tax is charged but marginal relief is due.

2.5 Where a company is associated with other companies the corporation tax thresholds (i.e. the lower and upper limits) are reduced accordingly. Broadly, the effect is to adjust the rate of tax to take account of the total profits of all associated companies, ensuring that each associated company's tax rate is reflective of it being part of a wider economic unit. The test for whether companies are associated are the rules governing 'control' of a company set out in section 450 of the Corporation Tax Act 2010.²

2.6 As they apply to the SPR, most aspects of these rules are fully in accordance with the intended policy objective. For example, where companies are part of a group or controlled through rights held by the same person or persons they are associated for the purposes of

¹ Formerly known as the small companies' rate of corporation tax (SCR).

² Previously section 416 of the Income & Corporation Tax Act 1988.

access to the SPR. In discussions prior to the consultation there was broad recognition that it is right that companies within a group or controlled by the same person(s) should be regarded as associated.

2.7 However, some aspects of the rules work in an automatic, mechanical manner that serve to associate companies controlled by separate individuals regardless of the wider circumstances. For example, the rules governing the attribution to a person of rights held by another person linked to them can be unfair. The aim for reform of the existing rules is therefore to provide a test that retains those aspects of the current test that work well within a new test that attributes rights held between linked persons only in circumstances where actual links between the companies make it appropriate to do so. The consultation sought views on a new test that seeks to ensure that companies cannot be associated by an attribution of rights by mere 'accident of circumstance'.

The consultation questions

2.8 The consultation invited responses from interested parties on the consultation questions below:

- 1 Do you feel that the proposed new test ensures that companies would only be associated when their level of interdependence means that it would be appropriate to do so?
- 2 If not, what aspects of the proposed new test should be amended?
- 3 Are there any areas that you feel the draft guidance does not cover and would benefit from further examples?
- 4 Do you have any views on the draft Impact Assessment?

3

Responses to the consultation

3.1 A total of 17 responses to the consultation were received from individuals, businesses and representative bodies. A subsequent meeting was held with interested parties to discuss the specific concerns raised during the consultation about the clarity of the legislation and guidance. A summary of the responses and the Government's response is set out below.

Question 1: Do you feel that the proposed new test ensures that companies would only be associated when their level of interdependence means that it would be appropriate to do so?

3.2 There was wide support for the policy rationale behind the proposed new test. Responses highlighted it as a "sensible" change, "perfectly appropriate", "desirable", and "should result, in the vast majority of cases, with companies being treated as associated when it is appropriate to do so." At the same time, some concerns were raised that moving from a mechanical test to the proposed test might "increase uncertainty" because it would, by necessity, turn on matters of fact and degree. Another considered it might be "unlikely to constitute a simplification" as a result.

3.3 Two responses also suggested the new test did not go far enough because companies controlled through rights held by the same person would remain associated for the purposes of access to the SPR.

The Government's response

3.4 The Government has responded to the main priority identified by stakeholders in the simplification of the associated company rules and welcomes the broad support for the reform so that companies cannot be associated by an attribution of rights by mere 'accident of circumstance'. As set out in the emergency Budget 2010, it will proceed with this reform and introduce legislation in Finance Bill 2011 that takes effect from 1 April 2011.

3.5 The Government does acknowledge the concerns around the possibility of increased uncertainty. This was raised with stakeholders prior to the publication of the consultation when the proposed test was initially discussed. Interested parties considered it to be an inevitable consequence of their desire to move away from the existing automatic, mechanical test towards one based on the individual facts of each case. It was agreed that as a result some uncertainty would always exist but clear legislation, with supporting guidance, would mitigate this and the benefit of the reform would outweigh the potential for uncertainty.

3.6 As set out in the previous chapter, it was agreed with stakeholders prior to the consultation that it would focus solely on the attribution of rights between associates. The new test only amends the circumstances in which rights held by linked persons are attributed between them to establish control.

Question 2: If not, what aspects of the proposed new test should be amended?

3.7 Despite the broad support for the policy change there was concern that the draft legislation lacked clarity and was, in some respects, inconsistent with the draft guidance. Some felt the legislation to be too broad and difficult to interpret without making reference to the guidance. To tackle this, some commented that the principles on which attribution of rights would be based (i.e. economic, financial and organisational interdependence) should be made explicitly in the legislation.

3.8 Others considered a “significance test” or *de minimis* could be included within the legislation to eliminate minor links from creating an association, with s.51G of the Capital Allowances Act 2001 cited as an example of an objective test to prevent the fragmentation of businesses.

The Government’s response

3.9 The Government has revised the draft legislation to express more clearly the circumstances in which rights should be attributed between associated persons. The revised legislation explicitly sets out that rights are only attributed between associates where “substantial commercial interdependence” exists between the relevant companies. In considering where this exists, regard should be had for the level of economic, financial and organisational interdependence between the relevant companies. While lengthening the legislation, the change ensures the policy objective of companies only being associated through attribution of rights in circumstances where the links between them make it appropriate to do so and sets out the relevant circumstances.

3.10 As stakeholders and respondents recognised, “substantial commercial interdependence” can exist in many ways and is thus difficult to define with absolute clarity. The revised legislation therefore takes the form of:

- a high level statement in primary legislation that the rights of linked persons will only be attributed where “substantial commercial interdependence” exists between companies; and
- specific detail, in secondary legislation, of the factors that determine whether “substantial commercial interdependence” exists.

3.11 This approach provides the legislative clarity that respondents requested. The power to set out the factors indicating interdependence by way of Treasury Order has the virtue of giving legislative clarity in a manner that, if required, can be amended in line with changes in the business world without the timing restriction of the annual Finance Bill. Interested parties at a meeting subsequent to the consultation welcomed this revised approach.

3.12 The Government does not believe a significance test is appropriate. Each case under the revised legislation will be dependent on its own facts and tax legislation often turns on such questions of facts and degree. A statutory significance test would create a new “cliff-edge” test of the type this reform seeks to replace. Furthermore, HMRC Extra Statutory Concession C9, on which this reform is based, specifically uses the test of “substantial commercial interdependence”. This test has been well understood and operated for many years without difficulties or the need for an additional significance test.

3.13 The revised draft legislation can be found at Chapter B. Further comments are welcome before the primary legislation is published in the draft Finance Bill 2011.

Question 3: Are there any areas that you feel the draft guidance does not cover and would benefit from further examples?

3.14 Responses on the guidance noted “the guidance is very good although, obviously, it cannot cater for every situation, and most situations will be more complicated than those presented”. The examples were described as aiding “interpretation of the legislation and are transparent as to its intentions”.

3.15 Some responses however suggested the examples in guidance did not provide sufficient clarity because, in some cases, they did not outline the specific interdependence leading to an association. Some also requested the guidance clearly set out the level of economic, financial or organisational interdependence required for companies to be considered associated.

3.16 Responses also made a number of suggestions for further examples that would be helpful to include in the guidance. These included circumstances where:

- spouses or civil partners owning different companies both work at home, while sharing childcare and household responsibilities;
- companies share premises;
- family businesses set up by one generation split into separate businesses when passing into ownership of next generation;
- there is financial assistance from a family member who is in another business;
- there are arms length transactions at commercial rates; and
- a private equity fund invests in a number of independent companies.

3.17 It was also suggested the guidance should include some practical advice about how to resolve any disagreements over interdependence and what additional information HMRC would seek in such instances.

The Government's response

3.18 The proposed revisions to the legislation explicitly set out the factors that must be taken into account when considering whether it is appropriate to attribute rights held by associated persons. While it is impractical for the guidance to cover every scenario, the guidance has been revised wherever possible to include the examples above and make the existing examples clearer. The revised draft guidance can be found at Chapter C and further comments are welcome. Further discussions will be held with relevant stakeholders in relation to private equity and the guidance will be updated to include appropriate examples if necessary.

3.19 The guidance provides practical advice on how HMRC will interpret the legislation in a range of scenarios. It is impractical to set out further what additional information may be required in the event of a dispute as it will depend on the facts of each individual case. Any disputes will be subject to the normal procedures and guidance can be found at www.hmrc.gov.uk/factsheets/hmrc1.pdf.

Question 4: Do you have any views on the draft Impact Assessment?

3.20 Only a small number of comments were received directly about the draft Impact Assessment. They suggested compliance costs could be more significant for some companies because a potentially complex judgement has to be made whether the interdependencies apply.

The Government's response

3.21 The Government acknowledges that the new test will, in some instances, involve a greater burden for the small number of companies that need to consider whether they are associated because of attribution rights. As set out above, this is the consequence of replacing the existing mechanical test in favour of delivering the priority reform requested by stakeholders during the course of the Review. In the majority of instances however, the attribution of rights play no part, or are only a very minor consideration, when deciding whether an association exists. Consequently, the Government believes the draft Impact Assessment represents a fair reflection of the average burden for companies considering matters of association but will make this clearer when producing the final Impact Assessment.

Other issues raised

3.22 The responses also highlighted a number of issues not directly related to the consultation questions.

3.23 One asked whether this meant HMRC Extra Statutory Concession C9 would be withdrawn as a result of these proposals. This states that where there is no substantial commercial interdependence between companies then, for the purpose of access to the SPR, they cannot be considered associated by virtue of an attribution of rights between relatives unless the attribution is between husband and wife or a child who is a minor.

3.24 One response suggested introducing a single rate of corporation tax to remove the need for the associated company rules as all profits would be taxed at the same rate no matter whether companies were associated or not.

3.25 Other responses commented on the scope of the consultation. Some suggested it should have also considered the case for removing the mechanical reduction of the thresholds by reference to the number of associated companies and replace this by applying the SPR to the total profits of all associated companies taken together. Others suggested the Simplification Review should consider the broader application of the associated company rules.

The Government's response

3.26 The Government confirms that HMRC Extra Statutory Concession C9 will be withdrawn when the new legislation is introduced.

3.27 The Government notes the suggested benefits of a single rate of corporation tax in terms of simplification. Tax rates are beyond the scope of this consultation.

3.28 The possibility of applying the SPR by reference to the total profits of all associated companies was discussed in detail with stakeholders prior to publication of the consultation. However, in those discussions there was collective agreement with the difficulties in a reform of this nature and so the published consultation did not focus on it. These difficulties include:

- problems arise when company A is associated with companies B and C but where there is no association between B and C. Company A may have no other associates apart from B and C, so for it thresholds are reduced by two-thirds, whereas company C may have many associates so that its thresholds are reduced to a small fraction. As a matter of policy it is highly difficult to decide the total amount of relief that company B should be allowed to share in and so there is no rational basis for resolving disputes between the companies as to what amount of relief each should get; and

- it would be particularly difficult where accounting periods do not coincide and also where the associated companies are not UK resident or trading within the UK and therefore not within the charge to corporation tax.

3.29 The Government has been unable to find a practical solution to these issues and neither stakeholders prior to the consultation nor those raising the issue again during the consultation have been able to find solutions to resolve these difficulties either. The Government does not therefore currently plan to act but remains open to further discussions if a practical solution can be found.

3.30 The Government also notes the suggestion there is interest in reviewing the associated company rules more broadly. Reforms have been introduced to tackle the specific issues identified as the main priorities identified by stakeholders during the Simplification Review process launched in 2007 and has now delivered on those areas. The associated company rules, as with all taxes, will be kept under review in the future.

4

Next steps

4.1 As announced in the emergency Budget 2010, legislation will be introduced in the Finance Bill 2011 to reform the associated company rules as they apply to the SPR. This will take effect from 1 April 2011.

4.2 The Government is currently consulting on improving the scrutiny of tax legislation.¹ It has proposed a minimum of 8 weeks for comments on draft Finance Bill legislation and 4 weeks for comments on draft secondary legislation where it makes a substantive change to the tax code. Ahead of formal publication for comment consistent with those principles, earlier comments on the draft legislation or draft guidance in Chapters B and C are welcome and can be sent to:

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4.3 The Government has delivered the priorities identified by stakeholders during the scoping stage of the Simplification Review in 2007 and discussions over the past three years. It will now formally close this strand of the Related Companies Simplification Review but will continue to keep the associated company rules under review should further reforms be necessary in the future.

¹ *Tax policy making: a new approach*, HM Treasury, June 2010, http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm

A List of respondents

There were 17 responses received to the consultation. The following representative bodies submitted responses, with the remainder being received from individuals, businesses or accountancy firms:

- Association of International Accountants
- Association of Taxation Technicians
- British Venture Capital Association
- Chartered Institute of Taxation
- Institute of Chartered Accountants in England and Wales
- Institute of Directors
- London Society of Chartered Accountants

B

Revised draft legislation

The revised draft primary legislation is set out below. This takes account of comments received during the consultation process and in subsequent discussions.

Small profits rate: associated companies

(1) Section 27 of CTA 2010 (meaning of “associated company”: attribution to persons of rights and powers of their partners) is amended as follows.

(2) In the heading, for “their partners” substitute “associates”.

(3) In subsection (1), omit “(“the taxpayer company”)”

(4) In subsection (2), for “(“P”) include a partner of the person” substitute “have effect for the purposes of this section”.

(5) For subsections (3) to (6) substitute-

“(3) The condition is that there is substantial commercial interdependence between the companies.

(4) The Treasury may by order prescribe factors that are to be taken into account in determining whether a relationship between two companies amounts to substantial commercial interdependence for the purposes of this section.”

The draft secondary legislation and explanatory note is set out below. This takes account of comments received during the consultation process and in subsequent discussions.

The Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Order 2011

The Treasury makes the following Order in exercise of the powers conferred by sections 27(4)(a) and 1171(4) of the Corporation Tax Act 2010⁽¹⁾.

Citation and commencement

1. —(1) This Order may be cited as the Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Order 2011.

(2) This Order shall come into force on [day] [month] 2011.

⁽¹⁾2010 c. 4. Section 27(4) was inserted by section XX of the Finance Act 2011 (c. XX).

