



The Law Society

Finance (No. 2) Bill

Committee Stage: Written evidence submission

May 2013



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Memorandum submitted by the Law Society of England and Wales

Introduction

1. The Law Society of England and Wales is the independent professional body, established for solicitors in 1825, that works globally to support and represent its 166,000 members, promoting the highest professional standards and the rule of law.
2. This submission has been prepared by members of the Law Society's Tax Law Committee, which is made up of practitioners who are experts in the field of tax law, with experience of advising both corporate and private clients.

Summary

3. Currently the Society believes there are important deficiencies in the legislation that will lead to considerable uncertainty. One fundamental reservation is the scope of the loss restriction rules outlined in clause 32. Our submission focuses on this clause.
4. The Society proposes that Clause 32 should be deleted from the Bill. The purpose of the amendment is to allow time for consultation on the appropriate scope of the loss restriction rules following a change in ownership and company reconstruction, and any changes required to enable HMRC to counter transactions that seek to avoid the scope of the loss-restriction rules while not adversely affecting transactions that are not the original target of the loss-restriction rules.

Clause 32

5. Clause 32 amends section 676 Corporation Tax Act (CTA) 2010. This section is one of a series of provisions (the "loss restriction rules") dealing with restrictions on the use of a company's carried forward losses following a change in ownership.
6. Broadly these losses are restricted – and can only be used against profits of the company arising before the change in ownership – where, following a change in ownership, "a dying trade [is] brought back to life and/or important changes are made to the trading activity" of the company (see HMRC's Company Taxation Manual 06310).
7. The purpose of these provisions is described in paragraph 06305 of the Company Taxation Manual as follows: "[This part] counters 'loss-buying', where a person buys a trading company wholly or partly for its unused trading losses rather than solely for the inherent value of its trade or assets.
8. The new owner usually introduces new activity into the company, but in such a way that it would be difficult to persuade a Tribunal that one trade had ceased

and a new one commenced. Thus, but for CTA10/S673, the company would keep its entitlement to relief for losses brought forward." The focus of the provisions is therefore on situations where at least part of a purchaser's motivation in buying a trading company is its unused trading losses.

9. Clause 32 deals with the interaction of these loss restriction rules with other rules that apply when a business is transferred within a group. In general, on an intra-group transfer of a business, any tax losses that are attributable to the business are automatically transferred along with the business. Because the transferee will not have suffered a change in ownership, the loss restriction rules will not apply and the transferee can use the losses without restriction against the profits of the transferred trade (but not against other profits) even if there is a change in the way that it is carried on. The purpose of clause 32 is to make the loss restriction rules apply in these circumstances.
10. This clause has been introduced without consultation on the basis that it is an "anti-avoidance" rule. It is true that the current drafting of s676 CTA does permit transactions to be structured to get around the loss restriction rules that ought to be caught by them. However, it also enables transactions that arguably should not be caught by the loss restriction rules in the first place to be structured so that a company can continue to use its losses appropriately. The structuring is widely known in the market and most tax practitioners would not think that it was an inappropriate use of the rules, unless it were deliberately used in cases of explicit loss-buying.
11. An example of a situation where structuring may be appropriate is where a purchaser (P) buys a target (T) which has a valuable asset, for example intellectual property, and some carried forward trading losses. After the purchase, P wishes to put the intellectual property into the group's IP holding company, to align the management of the newly acquired IP with that of the current IP in the group. The IP holding company may not be in the UK, which would result in T making a taxable disposal. If the IP is sufficiently significant to T's business, the transfer could result in a major change in the conduct of T's trade, which, coupled with the change in ownership of T, would trigger the loss restriction rules. The result would be that T could not use its carried forward losses to shelter the gain on disposal of the IP. This is a rather arbitrary result, because if T had sold the IP to P, or the IP holding company, before the change in ownership, then it would have been able to use the losses.
12. Accordingly, in such a situation, the transaction might have been structured to take advantage of the current form of s676, so that T's business would first be transferred to another UK group company before the disposal of the IP. This would allow the carried forward losses to be used against the disposal. In policy terms this seems like the right outcome – there is no question of P introducing profits or otherwise taking the benefit of the losses in its own business. Instead, T is allowed to use the losses to shelter gains on the disposal of its assets, whether that disposal takes place before or after the change in ownership.
13. This issue has been known to HMRC for some time. In the July 2012 consultation on the disclosure rules "Lifting the Lid", references were made to these sorts of transactions as being of concern to HMRC. Representations were made by tax professionals at that time that such structuring did not seem sufficiently out of the ordinary to warrant inclusion in the disclosure rules. In the

December 2012 response to the consultation, HMRC accepted that in the context of the disclosure rules, further consultation would be necessary to ensure that any inclusion of loss-buying transactions was appropriately targeted. Our view is that the same could be said of clause 32. There has been plenty of time for HMRC to consult on changes to section 676. To introduce them with immediate effect from Budget day seems like a complete over-reaction by HMRC. A consultation as to how the rules should be properly amended would seem to be more in line with the "Tax Consultation Framework" published in March 2011 by HMRC and HM Treasury.

14. Clause 32 should be removed from the Bill. This will allow time for consultation on the appropriate scope of the loss restriction rules following a change in ownership and company reconstruction, and any changes required to enable HMRC to counter transactions that seek to avoid the scope of the loss-restriction rules while not adversely affecting transactions that are not the original target of the loss-restriction rules.

Clause 42, page 18, line 34

15. Amendments to the regulatory requirements relating to tier two capital have caused uncertainty about their treatment for tax purposes. As a result, clause 42 attempts to clarify the position for corporation tax, amongst other things by ensuring that a loan made to a bank that qualifies as tier two capital resources should be treated as a normal commercial loan for the purposes of corporation tax. An equivalent issue arises in relation to stamp duty and stamp duty reserve tax, but that legislation has not been clarified. The proposed amendment below would align the position in relation to stamp duty on tier two capital instruments with the treatment for corporation tax.
16. We propose that the clause is amended as follows: in clause 42, insert a new subsection (6), and renumber the existing subsection (6) as subsection (7), to read

'Amend section 79 Finance Act 1986 as follows:

(a) in sub-section 5, following the first instance of "loan capital", insert "(other than loan capital which constitutes tier two securities within the meaning of section 1032A Corporation Taxes Act 2010)"; and

(b) in sub-section (6), , following the first instance of "loan capital", insert "(other than loan capital which constitutes tier two securities within the meaning of section 1032A Corporation Taxes Act 2010)"

Clause 174 and Schedule 34 – Treatment of liabilities for inheritance tax purposes

17. Proposed s162A(1) Inheritance Tax Act 1984 (IHTA) - It is not clear what the word "financing" means.
18. Proposed s162A(1) IHTA – Following on from the meaning of "financing" it is not clear whether the deposit of borrowed monies in an overseas bank account

(which would be excluded property) is the “financing” of excluded property. If this is to be treated as within the proposed provisions and the borrowed funds are then transferred to the UK or used to acquire UK property, the new provisions should cease to apply i.e. the borrowing should become allowable if the funds are used to acquire UK property. The transfer of funds from an overseas account to a UK account, or their use to buy UK property is not obviously a “disposal” of the asset for full consideration as required by the current provisions. The legislation should make clear that the debt will be allowable in these circumstances.

19. Proposed s16A(1)(a) IHTA – We consider that consideration should be given to permitting a liability which is attributable to the acquisition of excluded property of a type which amounts to an investment into “UK plc” (e.g. a holding in AUTs or shares in OEICs -s6(1A) IHTA) to be taken into account for IHT purposes.
20. Proposed s162A(2) IHTA – It is not clear whether a liquidation of a non UK company, the shares of which are owned by a non domiciliary (i.e. the shares are excluded property) which company owns UK property, would be a ‘disposal for full consideration in money or money’s worth’ such that any liability which is attributable to the acquisition of the excluded property (the shares) could be taken into account for IHT purposes.
21. We consider that the debt should be allowable in these circumstances and, indeed, in any circumstances where a non-domiciliary or a trust established by a non-domiciliary ceases to own excluded property and the excluded property is replaced by UK assets.
22. Proposed s162A(3) IHTA – This section applies where a liability is greater than the value of the excluded property. It does not apply where the original excluded property has been disposed of. The section should apply to any replacement excluded property as well as the original excluded property.
23. Proposed s162A(3)(b) IHTA – We consider that any increase in the amount of the liability due to currency fluctuations should be taken into account and that increase in the amount of the liability due to the accrual of interest or say index linking should be able to be taken into account where the arrangement was entered into at arm’s length or is on arm’s length terms.
24. Proposed s162B IHTA – it is unclear how a personal representative (PR) will necessarily know whether a liability was used to “finance” relievable property. Please could it be confirmed that it is sufficient that the PRs need only take reasonable steps to ascertain whether a liability is attributable to financing such property.
25. Proposed s175A(2) IHTA – we consider that this section will compound the problems that PRs already have in having a liability to pay IHT before they have the grant of probate. Until the PRs have paid IHT they cannot get a grant of probate but until they have a grant of probate they will not be able to realise assets in order to pay the IHT. If the deceased had a liability which the PRs intend to repay but there are insufficient assets readily available in the estate to repay the liability before the grant of probate is obtained, then the PRs must find not only the IHT on the net value of the assets but must also fund the discharge of the liability or face paying IHT on the value of the assets unreduced by the liability. There is no provision dealing with the possibility that a liability may be

discharged after the IHT is paid. Section 175A(1) requires the liability to being discharged “out of the estate” which we interpret to mean that the payment must be made in the course of administration. We consider that it should be assumed for the purposes of calculating the IHT liability, that the PRs will repay the liability but that HMRC be entitled to revisit the position some time, say two years, after the deceased’s death or the period of the administration whichever is longer and that if the liability has not been discharged by that time that it be assumed that the liability will not be discharged and IHT (subject to interest but not penalties) be paid accordingly. If it transpires that the liability is indeed subsequently discharged after two years, the increased IHT previously paid should (subject to interest) be repaid to the estate.

26. Proposed s175A(2)(a) and s175A(3)(a) IHTA – we note that there is a ‘real commercial reason for a liability not being discharged’ where it is shown that the ‘liability is to a person dealing at arm’s length’. It is odd that in order to establish whether a commercial reason exists for a liability not being discharged this, we assume, requires an assessment of the state of affairs (whether or not the parties were dealing at arm’s length) which existed at the time when the liability was taken out. We note that IHTM 04164 says that

“arm’s length’, implies the absence of any relationship between the parties such as might lead to one being favoured by the other. In this context, relationship is used in its broadest sense and so may include close friendship as well as consanguinity.

In considering whether this requirement is satisfied, you should consider all available evidence. Factors to bear in mind include

- *whether the parties were separately advised, and*
- *whether negotiations show a sequence of offer and counter offer.*

27. We consider it unreasonable for the PRs to have to ascertain whether the parties to a transaction which may have occurred many years previously, were separately advised and how the negotiations between them proceeded.
28. Proposed s175A(3)(a) IHTA - If it is intended that the terms on which the liability was originally entered into are to be considered by the PRs we think that it would be clearer to refer to the liability being “entered into on arm’s length terms” rather than between parties dealing at arm’s length. If the existing wording is to be retained, we should suggest that there is a presumption that persons are dealing at arm’s length where the counterparty was not connected to the deceased.
29. Please could there be guidance on other circumstances where there will be a “real commercial reason” for non-repayment. For example, will a lack of liquidity be sufficient?
30. Proposed s175A(3)(b) IHTA - we do not consider it reasonable that PRs must ascertain not only whether the deceased’s liability is to the other party was a dealing at arm’s length but must also speculate whether, if the liability were to a person dealing at arm’s length, that person would not require the liability to be discharged.

Clause 175 – Election to be treated as domiciled in the UK

31. Proposed s267ZB(5)(a) IHTA – We consider it unfair that the earliest a lifetime or death election can be treated as having taken effect is 6 April 2013. We consider that the start date should be the date the policy was announced (i.e. 12 December 2012).
32. Proposed s267ZB(5)(c) IHTA requires that a date ('the date concerned') must meet a condition (the one in subsection (6)). It seems odd to require that a date must meet a condition.
33. Proposed s267ZB(5)(c) and s267ZB(6) IHTA The condition is met by the 'date concerned' if throughout the period from the date concerned to a later date (the date on which the election is made in the context of a lifetime election or the date immediately before the death of the spouse or civil partner in the context of a death election) the person making the election was married to a UK spouse. Even if a date can be required to meet a condition (see above) it seems odd to assess whether it meets a condition by reference to later events. Bearing in mind our later comment that we consider that the elector need only be married or in a civil partnership with the UK spouse/civil partner at the time of any relevant transfer of value and not necessarily at any later date, we consider that proposed s267ZB(5)(c) should simply require the parties to have been married or in civil partnership on the date on which the lifetime or death election is to be treated as having taken effect.
34. We consider that the elector need only be married to or in a civil partnership with the UK spouse/civil partner at the time of any relevant transfer of value and not necessarily at any later date. The proposed s267ZB(5)(c) should simply require the parties to have been married or in civil partnership on the date on which the lifetime or death election takes effect or is to be treated as having taken effect.
35. Proposed s267ZB(6) IHTA (which requires the person making the election to have been married to the UK domiciled spouse) does not take into account the fact that the person making the election might be the person's PRs.
36. Proposed s267ZB(6) and (7) IHTA require the elector to have been married or in a civil partnership with the UK spouse/civil partner throughout the relevant period (in the case of a lifetime election, the period beginning with the date concerned and ending with the date on which the election is made and in the case of a death election, the period beginning with the date concerned and ending immediately before the death of the spouse or civil partner). We consider that the requirement should be that the elector was married or in a civil partnership with the UK spouse/civil partner at the time of any relevant transfer of value (as is required with intra-spouse transfers between UK domiciled spouses) not necessarily at any later date.
37. Proposed s267ZB(12) IHTA – it is not clear how this clause interacts with the new split year treatment for tax purposes under the proposed statutory residence test.