HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Martin Caton and Christopher Chope
Chairmen of the Public Bill Committee
House of Commons
London
SW1A 0AA

18 **October 2010**

Dear Martin and Christopher

Powers contained in Finance (No.2) Bill 2010

In order to allow the Members time to examine the secondary legislation under this year's Bill, I am providing information on each power being taken. Powers are contained in clauses 1, 5, 8, 11, 18-19, 24-28 (and their accompanying Schedules, where applicable).

Clause 1, Schedule 1 – Shared lives care

Paragraph 7 of Schedule 1 introduces new section 806A of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

New section 806A(4) of ITTOIA confers powers to set out the conditions which have to be met by an individual in order to qualify for qualifying care relief. One of the requirements is that the individual provides accommodation and care for an adult or child that has been placed with the individual under a specified social care scheme (section 806A(2)(c)). The order will set out what schemes will be "specified social care schemes" and specify the conditions that each of these schemes have to meet in order to satisfy the qualifying condition (set out in section 806A(2)(c)).

It will have effect for the tax year 2010-2011 and subsequent tax years and will come into force before the end of the current tax year. A draft of the order will be made available for consideration by interested groups as soon as possible.

Clause 5, Schedule 2 – Venture capital schemes

The Bill introduces new powers in Schedule 2.

These powers allow for modifications of the definitions, introduced in the Bill, of a "permanent establishment" for the purposes of the test in new sections 180A and 286A of the Income Tax Act 2007 (ITA) and of a "regulated market" in section 274 of ITA, should this become necessary.

These powers are not being exercised at the present time. Draft guidance is enclosed on the new definitions introduced by Schedule 2 ("permanent establishment" and "enterprise in difficulty") and on the amended definition of "eligible shares" for "Venture capital trusts."

Clause 8 Collection of income tax where sum deducted by payer

Clause 8 provides HM Revenue and Customs with a power to amend the provisions relating to income tax deducted at source from interest and similar payments made by individuals and non-corporate persons. The power is limited to amending the time and manner in which a person may be required to report and pay any withheld tax to HMRC, and only has prospective effect.

Changes to the collection procedures depend on the implementation of changes to HMRC's computer systems, which are currently being worked on, and will not be concluded for some time.

Regulations made under this power are likely to be laid later this year or early next year when the implementation work is complete.

Clause 11, Schedule 5 – Financing costs and income of group companies

Paragraph 25 of Schedule 5 Mismatches between tax treatment and accounting treatment:

The "debt cap" rules introduced in Finance Act 2009 limit the amount of a UK group's tax deduction for interest to the amount of interest shown in the worldwide accounts of the group of which the company is a member. Effectively this limits the tax deduction of the UK group to interest and financing costs from borrowings made from parties outside the group. The UK group's tax deduction is first measured as the total of the financing expenses less financing income for each UK group company. If the UK group's financing expenses are greater than financing income, the balance is the "tested expense amount". If vice versa the balance is the "tested income amount". If there is a tested expense amount, then this is compared with the amount of interest and other finance expenses in the worldwide accounts of the group. This is called the "available amount" and if the tested expense amount is higher then the UK group's total tax deduction is limited to the available amount.

New section 331A will confer a power on the Commissioners for HMRC to make regulations to change the way in which the "tested expense amount" or "tested income amount" is calculated where there is a difference between the amounts shown in the accounts of the UK company and those in the accounts of the worldwide group. For example, if the accounting method used in the consolidated accounts of the worldwide group is different from that used by the UK company then, subject to certain conditions, the tested expense amount or tested income amount of the UK group is adjusted to compensate for the difference.

The power extends to making the regulations with limited retrospective effect; they may apply to the period of account of a worldwide group beginning on or after the beginning of the calendar year in which the regulations are made. However the regulations may also allow the worldwide group to elect for the regulations to apply prospectively or to elect out completely.

Paragraph 28 of Schedule 5 Mismatches between tax treatment and accounting treatment

New section 336A will confer a similar power as that in new section 331A. It will enable the Commissioners for HMRC to make regulations to change the way that the available amount is calculated where there is a difference between the amount of expenses shown in the accounts of the worldwide group and the deduction claimed for tax purposes by the UK company.

The power also extends to making regulations with limited retrospective effect and may also allow the worldwide group to elect to opt out completely or for the regulations to apply prospectively.

Paragraph 33 of Schedule 5 New section 353B Regulations and orders

Special purpose vehicle companies used in securitisation arrangements are frequently bankruptcy remote, with their share capital owned by a charitable trust. However the accounts of the worldwide group will normally include such companies. It is possible that such companies will have a tax liability because of the operation of the debt cap rules; this will affect the credit rating of the debt issued by the special purpose vehicle company and increase the finance costs of group.

New section 353A will confer a power that will enable the Commissioners for HMRC to make regulations so that a group can elect to transfer the responsibility for discharging the tax liability of a company party to a capital market arrangement to another UK group company. This will ensure that the credit rating of the debt issued by the special purpose vehicle company is not reduced because of the operation of the debt cap rules. If an election is made, the other UK group company takes sole responsibility for discharging the tax liability and the liability is treated for all purposes as if it were a liability of the UK group company and not that of the special purpose vehicle company.

The election is a joint election and the power allows the regulations to include provision on when an election can be made, in particular that it may be made before the accounting period in which the liability arises.

The regulations may also include provision for the circumstances in which HMRC may accept or reject an election, terminate an election, the effect of such a termination and for the transfer of penalties to the UK group company.

New section 353B inserts a new power into Part 7 of the Taxation (International and other Provisions Act) 2010 (TIOPA 2010) to make different provision for different cases or circumstances, include supplementary, incidental and consequential provisions or make transitional provisions and savings. The new section will apply to regulations made under the existing power at section 332 (1) (g) TIOPA 2010 which enables the Commissioners for HMRC to add to the categories of amounts included within the available amount.

Draft regulations made under section 332(1) (g) are attached. They provide for the addition of amounts arising from "quasi loans" which may not, in themselves, strictly be borrowing but which are treated for tax purposes as if they are. To be included in the available amount the amounts must be financing expense for the UK company and deducted in arriving at the profits of the worldwide group.

The regulations will apply to accounting periods beginning on or after 1 January 2010, which is the first accounting period to which the primary legislation applies.

Clause 18, Schedule 7 – First-year allowances for zero-emission goods vehicles

There are various powers included that enable the Treasury to amend certain parts of what will become sections 45DA, 45DB and 212T CAA 2001.

Section 45DA(4) provides for specified descriptions of certain vehicles to be treated, or not treated, as a qualifying zero-emission goods vehicle. This is to allow the relief to be adjusted to take account of technological developments, should the need arise;

Sections 45DB(6) to (10) provide that expenditure to the extent that it is funded by a grant or subsidy that is a notified State aid, is ineligible for the allowance. While this should be sufficient to ensure compliance with State aid rules, 45DB(7)(b) contains a power to provide that other grants or subsidies towards expenditure that otherwise qualifies for relief, can also be declared relevant for the purpose of limiting the amount of the new allowance should it be necessary;

Section 45DB(12) allows for appropriate changes to be made to section 45DB that may be required as a result of amendments to, or the consolidation of, certain specified European regulations and treaties in respect of State aid. It ensures that the new allowance can be adjusted so that it continues to be an aid that does not need to be notified to the European Commission. It is very unlikely this power will be exercised; and

Section 212T(5) enables the amount of expenditure incurred on zero-emission goods vehicles that is eligible for the relief, (which is set at €85,000,000 to comply with State aid rules) to be increased should currency fluctuations allow.

It is not proposed that they be used at this time so there is no draft secondary legislation.

Clause 19, Schedule 8 – Non-business use of business assets etc

Schedule 8 makes changes to the VAT rules relating to the treatment of certain business assets. They implement part of an EU Directive which takes effect from 1 January 2011 and protect VAT revenue following an ECJ decision. Paragraph 1(5) of the Schedule contains a power for HMRC to make regulations to introduce an adjustment mechanism for changes in business use of certain assets as required by the Directive. Regulations made under this power would be made and laid prior to the commencement of the Directive, and would be subject to the negative resolution procedure.

A draft order made using this power will be published on the HMRC website for comment before it is laid.

Clause 24 Landfill tax: criteria for determining material to be subject to lower rate

Clause 24 will put in place the legislative basis for a duty upon HM Treasury to set criteria to be considered in future when listing in an

Order materials qualifying for the lower rate of landfill. Specifically the clause:

- provides for the publication by HMRC and setting and review by HM Treasury of criteria for determining the lower rate of landfill tax; and
- directs that HM Treasury will have regard to these criteria when listing in an Order the materials that qualify for the lower rate.

The purpose of introducing the clause is to bring greater clarity to the criteria upon which certain waste materials are lower rated under the landfill tax.

In due course, HM Treasury will set the appropriate criteria under the new provisions and then make amendments to the statutory instrument which sets out those materials that are lower rated.

Clause 25 Interest: corporation tax and petroleum revenue tax and Clauses 26 & 27, Schedules 10 & 11 – Late filing and late payment penalties

Harmonisation of the interest and late filing and late payment penalty regimes requires significant change to old and complex tax legislation.

- The powers being taken, to make secondary legislation are necessary to enable HMRC to make any consequential changes that will be needed in order to replace the old legislation with the new regimes. It is not possible to specify the precise consequential changes necessary until the new regimes are

given effect, which may be some time from now. By providing a power to make secondary legislation these consequential changes, amendments and repeals can be made easily and efficiently at the same time as the orders appointing the day the new regimes are to be given effect.

An identical approach was taken in respect of the provisions in Finance Act 2009 in which the majority of the legislative framework for the new harmonised interest and penalties regimes was introduced. Orders made under the provisions of last year's Act were published on the HMRC website ahead of being laid before Parliament, and did not attract any comment.

Implementation of the new harmonised interest and penalties regimes will be in stages over a period of years, and the orders will be drafted and laid as and when appropriate. Draft orders will continue to be published on the HMRC website ahead of being laid before Parliament.

Clause 28 Recovery of overpaid stamp duty land tax and petroleum revenue tax etc

The power enables HM Treasury to make any incidental, supplemental, consequential, transitional, transitory or saving provision which appears appropriate in consequence of, or otherwise in connection with the introduction of overpayment relief for stamp duty land tax and petroleum revenue tax.

At this point, there are no plans to use the power to make secondary legislation. No statutory instruments have been drafted.

I am copying this letter to all members of the Committee and to the Clerk to the Committee and depositing a copy in the Library of the House.

Yours ever

David Gauke MP

Draft/EXPLANATORY MEMORANDUM TO

THE TAX TREATMENT OF FINANCING COSTS AND INCOME (AVAILABLE AMOUNT) REGULATIONS 2010

2010 No. [XXXX]

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 Part 7 of the Taxation (International and Other Provisions) Act 2010 (chapter 8 of 2010) ("TIOPA 2010") contains provisions relating to the tax treatment of financing costs and financing income. Part 7 includes provisions which set a ceiling (known as "the available amount") on the total interest and other specified financing expenses for which corporation tax deductions are available to a group of companies. The purpose of these Regulations is to allow a wider range of financing expenses to be taken into account in calculating the available amount.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 Part 7 of TIOPA 2010 is one element of a package of measures introduced as part of the Government's review of the taxation of the foreign profits of companies.

4.2 The amount of interest and other financing expenses (known as the "available amount") that a group of UK companies (including permanent establishments of non-resident companies that are trading in the UK) may bring into account for the purpose of calculating their profits for corporation tax purposes is calculated by reference to the worldwide group to which the UK companies belong. The worldwide group may consist solely of UK companies and the UK permanent establishments of non-UK resident companies or it may include non-resident companies which do not have UK permanent establishments.

4.3 The available amount for the period of account of the worldwide group is the sum of the amounts disclosed in the financial statements of the group for that period. Section 332(1) of TIOPA 2010 describes those matters in respect of which amounts are included within the available amount. Subsection (1)(g) provides that HMRC may specify other descriptions of matters. These regulations do that.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 There are a number of arrangements which, although they are not loans in legal form, have the economic effect of loans and are treated for the purposes of Corporation Tax in the same way as loans. These include alternative finance arrangements (Islamic finance), repos (that is, sale and repurchase arrangements), and certain structured finance arrangements. Debts that arise from the supply of goods or services, rather than from lending money, are similarly treated.

7.2 A company entering into such an arrangement as the "borrower" will normally be allowed a tax deduction for amounts payable by it that are equivalent to interest, and such amounts will form part of the UK financing expenses taken into account under Part 7 of TIOPA 2010. These Regulations provide that the same amounts are also taken into account in computing the "available amount", thus ensuring that the comparison between UK and worldwide financing costs is made on a fair basis.

7.3 The Regulations provide that amounts payable in respect of the specified matters are included in the available amount, provided that they satisfy two general conditions. They are that the amount is actually deductible for tax purposes by a UK company within the scope of Part 7 of TIOPA 2010 and is shown as a cost of finance in the consolidated accounts of the worldwide group. The latter condition means that amounts relating to intra-group arrangements, which are eliminated on consolidation, will not be included in the available amount.

8. Consultation outcome

8.1 .

9. Guidance

9.1 HMRC will publish guidance on the operation of the Regulations.

10. Impact

10.1 An Impact Assessment has not been prepared for this instrument as it has a negligible impact on business, charities or voluntary bodies.

11. Regulating small business

11.1 The Regulations will not apply to small business.

12. Monitoring & review

12.1 .

13. Contact

[Insert name] at HM Revenue and Customs (Tel: 020 7147 or email: @hmrc.gsi.gov.uk) can answer any queries regarding the instrument.

The "Financial Health" requirement for EIS/VCT purposes

Sections 180B (EIS) and 286B (VCTs)

This legislation applies in respect of shares issues on or after [commencement date]. It was introduced as part of the conditions under which the schemes were granted State Aid approval by the European Commission.

For an EIS company issuing shares, the requirement is that the issuing company must meet the financial health requirement at the beginning of Period B – that is, at the date the shares are issued. [See VCM 20600 for an explanation of Period B].

For a VCT investee company, the requirement must be met at the time of issue of the relevant holding.

In both cases, the requirement is that at the relevant time, the company must not be "in difficulty". The company is "in difficulty" if it is reasonable to assume that it would be regarded as a firm in difficulty for the purposes of the European Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C244/02).

The EC Guidelines in question are lengthy, but the following paragraphs are most relevant for the purposes of the EIS and VCT rules:

> 9. There is no Community definition of what constitutes 'a firm in difficulty'. However, for the purposes of these Guidelines, the Commission regards a firm as being in difficulty where it is unable, whether through its own resources or with the funds it is able to obtain from its owner/shareholders or creditors, to stem losses which, without outside intervention by the public authorities, will almost certainly condemn it to going out of business in the short or medium term.
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> 10. In particular, a firm is, in principle and irrespective of its size, regarded as being in difficulty for the purposes of these Guidelines in the following circumstances:
>
> (a) in the case of a limited liability company, where more than half of its registered capital has disappeared and more than one quarter of that capital has been lost over the preceding 12 months;
>
> (b) in the case of a company where at least some members have unlimited liability for the debt of the company, where more than half of its capital as shown in the company accounts has disappeared and more than one quarter of that capital has been lost over the preceding 12 months;
>
> (c) whatever the type of company concerned, where it fulfils the criteria under its domestic law for being the subject of collective insolvency proceedings.

> 11. Even when none of the circumstances set out in point 10 are present, a firm may still be considered to be in difficulties, in particular where the usual signs of a firm being in difficulty are present, such as increasing losses, diminishing turnover, growing stock inventories, excess capacity, declining cash flow, mounting debt, rising interest charges and falling or nil net asset value. In acute cases the firm may already have become insolvent or may be the subject of collective insolvency proceedings brought under domestic law. In the latter case, these Guidelines apply to any aid granted in the context of such proceedings which leads to the firm's continuing in business. In any event, a firm in difficulty is eligible only where, demonstrably, it cannot recover through its own resources or with the funds it obtains from its owners/ shareholders or from market sources.
>
> 12. For the purposes of these Guidelines, a newly created firm is not eligible for rescue or restructuring aid even if its initial financial position is insecure. This is the case, for instance, where a new firm emerges from the liquidation of a previous firm or merely takes over such firm's assets. A firm will in principle be considered as newly created for the first three years following the start of operations in the relevant field of activity.

Whether it is "reasonable" to assume a company is "in difficulty" in this context, might be open to interpretation. HMRC intend to follow the example of the Guidelines and will not regard a company as falling within the scope of the restriction if at the date of issue of the relevant shares:

- It is within the first three years of operations in the relevant field of activity and/or
- It has been able to raise funds from its existing shareholders or from the market sufficient to meet its anticipated funding requirements at that time.

Draft guidance on "permanent establishment" for EIS/VCT purposes

Sections 180A and 191A (EIS); Sections 286A and 302A (VCT)

This legislation applies in respect of shares issued on or after [commencement date] and replaces the previous requirement that the issuing company or a qualifying 90% subsidiary carry on the qualifying trade wholly or mainly in the UK. It was introduced as part of the conditions under which the schemes were granted State Aid approval by the European Commission.

For an EIS company issuing shares, the requirement is that the issuing company must have a permanent establishment in the United Kingdom throughout Period B that is,at the date the shares are issued. [See VCM 20600 for an explanation of Period B].

For a VCT investee company, the requirement is that the relevant company must have a permanent establishment in the United Kingdom at all times from the issue of the holding to the time in question.

The legislation does not stipulate where the monies raised under the schemes, are to be used.

"Permanent establishment" is defined for the purposes of the Venture Capital schemes in the body of the legislation, at section 191A and section 302A. **Note:** the definition is slightly different from that at section 148 FA 2003 which serves for the purposes of the remainder UK Taxes Acts. This is so that the definition can be tailored as necessary for the purposes of the schemes, without the need to modify the more general domestic definition.

The definition is based on Article 5 of the OECD Model Tax Convention. The OECD provides a detailed commentary on each Article of the Model Convention to assist with interpretation. That commentary cannot be replicated in this guidance as HMRC does not hold the full copyright, but it should be found without difficulty using common internet search facilities.

For a company to be considered to have a permanent establishment in the United Kingdom, either of the following must apply:

- It has a fixed place of business there through which the company's business is wholly or partly carried on, *or*
- an agent acting on behalf of the company has and habitually exercises there authority to enter into contracts on behalf of the company.

Fixed place of business

The legislation lists a number of examples, including: a place of management; a branch; an office; a factory, a workshop, a mine, oil or gas well, a quarry or any other place of extraction of natural resources; and a building site or construction or installation project.

This list is not intended to be exhaustive; the type of business will determine the type and nature of the premises or facilities required.

But these would qualify as a permanent establishment only if in relation to the business as a whole, the activities carried on there are not of a preparatory or auxiliary character. The legislation lists some examples of activities which might be considered to be preparatory or auxiliary in nature – for instance, storage or display of goods or merchandise belonging to the company; the maintenance of stock owned by the company for storage, display or delivery; the maintenance of stock owned by the company for the purpose of processing by another person; purchasing goods or merchandise or collecting information for the company.

But again, this list is not intended to be exhaustive and whether activities are considered to be preparatory or auxiliary will depend on the nature of the company's business as a whole. What is critical is the extent to which the activities of the fixed place of business form an essential and substantial part of the whole business.

For the purposes of this part of the venture capital schemes legislation, the following points may be worth noting:

- It is the business of the issuing or relevant company which is to be considered, and not the business of the group as a whole if the company is the member of a group. So where the issuing company is the parent company of a group and that company acts mainly as a holding company, there is no requirement that the business of one or more of its trading subsidiaries be carried on from the place of business in question. It will be sufficient that the administrative and management functions of the parent company be carried on there.
- Thus a UK registered parent company, which carries out the necessary functions of a parent company from a fixed place of business within the UK, is likely to be considered to have a permanent establishment within the UK regardless of where the activities of any trading subsidiaries are carried on.
- The legislation makes it clear that an overseas registered parent company will not be regarded as having a permanent establishment in the UK merely by virtue of the fact that it has a subsidiary which is resident in the UK, or which carries on its business there. An overseas parent company must itself have a permanent establishment in the UK for it to qualify.
- The issuing or relevant company must meet the requirements of the "independence" test at section 185(2) ITA 2007 or section 296(2) ITA 2007 – see VCM15110, VCM20510 and VCM62330.

Agent acting on behalf of the company

The legislation also allows a company to be treated as having a permanent establishment in the UK where an agent has and exercises authority in the UK to enter into contracts on behalf of the company. This test is offered as an alternative to the "fixed place of business" test and the company need only meet one of the tests to qualify.

Agents who are independent of the company – that is, who offer their agency services to the company in pursuit of their own business – are excluded. Examples of the types of agency business which would be considered to be independent are brokers and commission agents.

Merely maintaining an employee in the UK will not itself be sufficient to guarantee permanent establishment status. The agent (which may be an individual or a company) must have and must repeatedly use the authority to enter into contracts on behalf of the company or which are otherwise binding on the company. The contracts in question must relate to the substantive business of the company and not merely to matters which would be considered preparatory or auxiliary.

VCT scheme: qualifying holdings: meaning of 'control'

ITA/S313(4) For the purposes of the VCT scheme 'control' has the meaning given in CTA10/S450(3) (see CTM60200 onwards), subject to the following three modifications:

- Rights in respect of relevant fixed-rate preference shares (See VCM62334) are ignored,
- Rights of 'loan creditors' (see CTM60130) are ignored (but where a loan or a holding of loan stock is convertible into shares, the effect of these 'arrangements' must be considered in accordance with VCM62330).
- Rights to dividends carried by 'eligible shares' held by the VCT are ignored.

Thus the particular tests for control by a person set out in CTA10/S450(3) cover that possession of, or entitlement to acquire:

- The greater part of the company's issued share capital, excluding any which consists of relevant fixed-rate preference shares,
- The greater part of the voting power in the company
- Such part of the company's issued share capital as would entitle the person to receive the greater part of the company's income if it were all distributed, ignoring for this purpose any entitlement in respect of relevant fixed-rate preference shares and 'eligible shares', and ignoring all income which would be distributed to the holders of such shares,
- Such part of the company's issued share capital as would entitle the person to receive the greater part of the company's assets on a winding up, ignoring for this purpose any rights in respect of relevant fixed-rate preference shares, and ignoring all assets which would be distributed to the holders of such shares.

These modifications are unlikely to be of any significance in relation to control of a company by the investee company (see VCM15060) but are of considerable importance in relation to control of that company (see VCM62330), especially control of it by the VCT itself.

VCT scheme: approval: definition of eligible shares

ITA/S285

The definition of 'eligible shares' for the purposes of S274, (which differs from that at S273 -see VCM60700) changed in relation to accounting periods ending on or after [xx/xx/11]. From that date shares are 'eligible' unless they carry -

- A present or future preferential right to the company's assets on its winding up, or
- A present or future right to be redeemed, or
- A present or future preferential right to dividends where:
    - The rights attaching to the share include scope for the amount of the dividend to be varied based on a decision taken by the company, the shareholder or any other person. **Note:** this exclusion covers only those shares which carry preferential rights and does not therefore prevent the voting of dividends in respect of non-preferential shares, nor does it prevent shareholders from choosing to waive a dividend payment should they wish to do so; or
    - The right to receive dividends is "cumulative" – that is, where a dividend which has become payable is not in fact paid, the company is obliged to pay it a later time, normally once funds become available.

Note: the definition of 'eligible shares' for this purpose differs from the definition of 'eligible shares' as it relates to the VCT's own investments – see VCM 60145 [TBC]