



HM TREASURY



HM Revenue  
& Customs

# Simplification review:

the associated company rules as they apply to  
the small companies' rate of corporation tax

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**October** 2009





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# Basic information

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<b>Subject of this consultation:</b>	This consultation document outlines an option for reforming the associated company rules as they apply to the small companies' rate of corporation tax.
<b>Scope of this consultation:</b>	The Government wishes to understand whether the option presented would benefit business by providing a more targeted test to establish those companies that form an economic whole and thus whose profits should be considered collectively in establishing the rate of corporation tax that applies to them.
<b>Impact Assessment:</b>	An Impact Assessment is included in Annex D.
<b>Who should read this:</b>	This consultation is primarily for representative bodies of companies that would be affected and their tax advisers. However, the Government welcomes views from all interested parties.
<b>Duration:</b>	The consultation starts on 29 October 2009 and responses should be received by 22 January 2010.
<b>Responses and enquiries:</b>	<p>If you wish to respond to this consultation document, raise an enquiry about the scope of the consultation document or request a hard copy please contact: The Related Companies Simplification Review Team Room 2/N2 HM Treasury 1 Horse Guards Road London, SW1A 2HQ</p> <p>Alternatively, please email: <a href="mailto:relatedcompanies.simplification@hmtreasury.gsi.gov.uk">relatedcompanies.simplification@hmtreasury.gsi.gov.uk</a></p> <p>Telephone enquiries: 020 7270 4568</p>
<b>Additional ways to become involved:</b>	The Government may hold meetings with interested parties. Please contact The Related Companies Simplification Review Team at the above address if you would be interested in attending a meeting.
<b>After the consultation:</b>	The Government will collate and publish key responses as soon as possible after 22 January 2010.
<b>Getting to this stage:</b>	Following the announcement of the Related Companies Simplification Review at the 2007 Pre-Budget Report, the Government published an online survey to identify which areas the review should prioritise. Over 140 responses were received, which identified the associated company rules as they apply to the small companies' rate of corporation tax as a priority for reform. Following on from this, the Government has continued to listen to the views of business through informal consultation with a number of representative bodies and tax advisers. The aim of these discussions has been to identify the key issues with the current rules, and to develop workable proposals for simplifying the rules.



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# 1

## Introduction

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**1.1** In the 2007 Pre-Budget Report, the Government launched three reviews to evaluate how a range of tax policies could be simplified. These simplification reviews cover VAT, anti-avoidance legislation and corporation tax rules for related companies. This consultation document forms part of the Related Companies Simplification Review.

**1.2** HM Treasury and HM Revenue & Customs (HMRC) continue to work in partnership with business on the three reviews with the aim of creating simple yet effective tax rules. The Government is determined to ensure that the UK provides a world-class environment for business, and recognises that the simplicity of the tax system is an important factor in achieving this. The Government is therefore committed to ensuring that simplification is a priority when designing and reviewing tax legislation, alongside sound public finances and fairness.

### Related Companies Simplification Review

**1.3** Following the launch of the Related Companies Simplification Review at the 2007 Pre-Budget Report, the 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 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 companies' rate of corporation tax (SCR).

**1.4** At Budget 2008, the Government announced that it would modify the existing rules defining control of a company as they relate to the SCR where a director or shareholder is separately in a partnership. However, the Government recognised that this was only a first step in simplifying the rules, and has continued discussions with representative bodies and tax advisers to identify how the rules could be further reformed to ensure that they best meet their intended purpose. These discussions have identified that **the main priority for further reform are the rules governing control of a company through the attribution to them of rights held by one or more of their associates.**

**1.5** Following these discussions, the Government announced at Budget 2009 that it would consult on this further reform of the associated company rules as they apply to the SCR.

### Summary of proposals and consultation process

**1.6** The discussions with representative bodies and tax advisers have assisted the Government in developing a proposal to further simplify the rules, and details on this proposal are set out in Chapter 3.

**1.7** The Government would like to hear the views of interested parties on the proposals outlined in this consultation document, and Chapter 4 sets out a number of questions for consultation. Details on how to respond to this consultation are given in Chapter 5.



# 2

## Policy context and principles

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### Background

**2.1** 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. However, Finance Act 1972 introduced a lower rate of corporation tax for companies with small profits called the SCR. For 2009-10, the SCR is 21 per cent compared to the main rate of corporation tax of 28 per cent.

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

**2.3** However, where a company is deemed to be associated with other companies the corporation tax thresholds (i.e. the lower and upper relevant maximum amounts) are reduced accordingly. For example, where a company is associated with two other companies the lower and upper relevant maximum amounts are reduced to £100,000 and £500,000 respectively. Broadly, the effect is to adjust the rate of tax to take account of all the profits of associated companies, meeting the Government's policy aim of ensuring that each associated company's tax rate reflects it being a fragment of a wider economic unit.

**2.4** The existing rules that establish who controls a company and thus which companies are associated with each other are long-standing. However, aspects of the rules do not objectively test whether companies controlled by different people/persons are fragments of a wider economic whole as a result of the interdependencies between them. Current rules that attribute rights held by associates take no account of whether a business, or control over it, has been: deliberately fragmented to access a lower rate of tax or developed in separate but linked companies; or developed entirely independently by linked individuals. Rather they look to mechanical rules that apply regardless of the wider circumstances.

**2.5** The Government has previously recognised that, where control over a company exists through tax rules that automatically attribute rights and powers held by one person to another linked person, the rules can apply to companies in a manner unintended by the policy objective:

- HMRC Extra Statutory Concession C9 says that where there is no substantial commercial interdependence between companies then for the purpose of access to the SCR 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.
- Similarly Finance Act 2008, while leaving the main test of control and thus association for SCR purposes unchanged, made amendments to a specific aspect – namely the attribution of rights held by associates who are business partners. This change ensured attribution of rights held by associates who are business partners was restricted purely to situations where tax planning arrangements exist – providing an objective rather than subjective test.

## Discussions with stakeholders

**2.6** In addition to aiming for simplification of the legislation, responses to the online survey and subsequent discussions with representative bodies and tax advisers indicated that any reform of the rules should seek to more closely align tax outcomes with economic and commercial reality.

**2.7** While there was broad recognition that it is right that companies within a group or controlled by the same person(s) should always be held as associated, there was consensus that the current rules operate in a manner that does not always reflect the wider economic reality. Specifically, respondents requested a review of the automatic and thus subjective attribution of rights between linked persons, which causes companies to be associated when in reality they are linked merely by an 'accident of circumstance'.

**2.8** The proposal outlined in the next chapter therefore suggests an alternative test linked more closely to economic and commercial reality and which applies in a more objective manner than the current rules allow.

# 3

## Option for a new fragmentation test

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**3.1** As set out in the previous chapter, where a company is deemed to be associated with other companies the corporation tax thresholds are reduced accordingly. Broadly, the effect is to adjust the rate of tax to take account of all the profits of associated companies. The test for whether companies are associated are the rules governing 'control' of a company set out in Section 416 of the Income & Corporation Tax Act 1988.

**3.2** As they apply to the SCR, aspects of these rules are fully in accordance with the Government's 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 access to the SCR. However, as discussed in the previous chapter, some aspects of the rules, such as the attribution of rights held between linked persons, work in an automatic, mechanical manner that serve to associate companies controlled by separate individuals, regardless of the wider economic circumstances.

### Objective for a new fragmentation test

**3.3** The Government's aim for reform of the existing rules is 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. Put broadly, the new test seeks to ensure that companies cannot be associated by an attribution of rights by mere 'accident of circumstance'.

### Proposal for a new fragmentation test

**3.4** The proposed new fragmentation test can be seen in its entirety in Annex B.

**3.5** It is important to note that the proposed new test **would not** amend the status of companies within the same group or under the control of the same person or persons – these would still be automatically associated. The proposed new test would only amend the circumstances in which rights held by linked persons are attributed between them to establish control.

**3.6** The test follows the approach taken by both the Finance Act 2008 amendments to the SCR fragmentation rules (see paragraph 2.5) and Extra Statutory Concession C9, in seeking to ensure rights held are only attributed between linked persons where links between the companies are sufficient to consider them interdependent and thus fragments of a wider whole.

**3.7** The draft guidance in Annex C sets out that under the proposed new test, when establishing whether companies are associated, regard would be had for the level of economic, financial and organisational interdependence that exists between the relevant companies.

**3.8** As the guidance makes clear, the outcome of each case under the proposed new test would be dependent on its own facts. The examples contained within the guidance are only illustrative, and interdependence of all three types does not have to exist for the companies to be associated. If only one type of interdependence is present to a sufficient degree then the companies would still be deemed to be associated.

## Impacts

**3.9** As well as simplifying the existing legislation, the proposed reform would help to ensure fair tax treatment between taxpayers and remove distortions to commercial decision making by ensuring that economic outcomes and tax outcomes are more closely matched. A full impact assessment is included in Annex D.

# 4

## Consultation questions

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4.1 The Government invites responses from interested parties, including representative bodies of companies that would be affected and their tax advisers, on the consultation questions below.

### Consultation questions

- 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 Impact Assessment in Annex D?





# 5

## How to respond

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**5.1** This consultation document has outlined an option for reform of the associated company rules as they apply to the SCR. HM Treasury and HMRC will also consider other ideas suggested by respondents to this consultation document.

### How to respond

**5.2** The Government welcomes responses to the questions in this consultation paper, which are set out in Chapter 4. Any comments should be sent to:

The Related Companies Simplification Review Team  
Room 2/N2  
HM Treasury  
1 Horse Guards Road  
London, SW1A 2HQ

Alternatively, please email: [relatedcompanies.simplification@hmtreasury.gsi.gov.uk](mailto:relatedcompanies.simplification@hmtreasury.gsi.gov.uk)  
Telephone enquiries: 020 7270 4568.

Responses should be received by 22 January 2010.

### Confidentiality disclosure

**5.3** Information provided in response to this consultation document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

**5.4** If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury or HMRC.

**5.5** HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

### The Government's Code of Practice on Consultation

**5.6** This consultation is being conducted in accordance with Government's Code of Practice on Consultation. A copy of the Code of Practice criteria and a contact for any comments on the consultation process can be found in Annex A.





# The Government's Code of Practice on Consultation

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## About the consultation process

This consultation is being conducted in accordance with the Government's Code of Practice on Consultation. If you wish to access the full version of the Code, you can obtain it online at:

<http://www.berr.gov.uk/files/file47158.pdf>

## The consultation criteria

1. When to consult – Formal consultation should take place at a stage when there is scope to influence the policy outcome.
2. Duration of consultation exercises – Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Clarity of scope and impact – Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Accessibility of consultation exercise – Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. The burden of consultation – Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Responsiveness of consultation exercises – Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Capacity to consult – Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Better Regulation Unit  
Email: [richard.bowyer@hmrc.gsi.gov.uk](mailto:richard.bowyer@hmrc.gsi.gov.uk)  
Telephone: 020 7147 0062



# B

## Draft legislation

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The proposed draft legislation is set out below.

### **Small companies' relief: fragmentation**

- (1) Section 13 of ICTA (small companies' relief) is amended as follows.
- (2) In the second sentence of subsection (4) (meaning of "control" for purposes of definition of "associated company"), for "include a partner of the person" substitute "have effect for the purposes of this section".
- (3) In subsection (4B) (meaning of "relevant tax planning arrangements") –
  - (a) in paragraph (a), for "partner" substitute "associate", and
  - (b) in paragraph (b), insert at the beginning "(apart from subsection (4)) would".
- (4) In subsection (4C), in the definition of "relevant tax advantage", for "virtue of an increase in" substitute "obtaining, or obtaining an increase in,".





# Draft guidance

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This draft guidance accompanies the proposed draft legislation set out in Annex B. It will be amended in light of comments and suggestions received during the consultation period.

## **CTM03750 – Corporation Tax: small companies: attribution to a person of rights and powers of associates – ‘fragmentation’ of a business**

### **ICTA88/s13(4), (4A), (4B) and (4C)**

When you are deciding who controls a company, you should sometimes take into account not only those rights which a person (including his nominees see CTM03740) possesses or is entitled to acquire, but also the rights of some other people within s416(6).

The policy for this is that the rate of corporation tax applying to a company should reflect whether it is part of a wider whole. A wider whole can either take the form of companies controlled by the same person(s) **or** companies controlled by different persons that nonetheless constitute a wider whole because of the interdependencies they share with each other.

Whilst the rights of a person and his nominees are therefore **always** taken into account, you **only** take into account the rights of others **in limited circumstances**. Those circumstances are where there are ‘relevant tax planning arrangements’, either in the period concerned or in another period and the effect extends into the period concerned.

‘Relevant tax planning arrangements’ are defined in ICTA88/s13(4B) as any arrangements involving the person and an associate of that person which secure a relevant tax advantage.

ICTA88/s13(4C) sets out that:

- arrangements include any agreement, understanding, scheme, transaction, series of transactions whether or not legally enforceable, excepting only guarantees, securities and charges given or taken by a bank; and
- a relevant tax advantage is a reduction in the liability to corporation tax because of getting (or increasing) relief under the small companies’ rate.

The statutory rules are therefore of very wide possible application, but you should bear in mind that their practical application will depend on a balanced and proportionate view of the various matters of fact and degree that may be present in a particular case.

Broadly, the rules will apply to those cases involving ‘fragmentation’ of the business activities which includes circumstances where related business activities have not been aggregated into the business of a single company. CTM03775 onwards gives more details and some examples.

If there are relevant tax planning arrangements, then you attribute to a person the rights of:

- associates (see CTM60150); and
- any companies which the person controls or the person and associates together control.

In both cases, the attributable rights will be inclusive of any rights of their nominees which must be attributed to the associate or company under ICTA88/s416(5) – see CTM03740. However,

you must not include the rights of 'associates of associates', that is those attributed to an associate under s416(6).

## **CTM03775 – Fragmentation – Relevant tax planning arrangements**

### **Contents**

CTM03780	Fragmentation and financial, economic and organisational links
CTM03785	Financial links
CTM03790	Economic links
CTM03795	Organisational links
CTM03800	What HMRC do not consider to be fragmentation of control

## **CTM03780 – Fragmentation – Fragmentation and financial, economic and organisational links**

### **ICTA88/s13(4A), (4B) and (4C)**

A company is treated as an associated company of another at a particular time if one of the two has control of the other or both are under the control of the same person (or persons).

From [the date of introduction], there are new rules that determine 'control' for the purposes of the small companies' rate ICTA88/s13. Under the new rules, attribution of rights held by associates of participators only applies where there are 'relevant tax planning arrangements'. These exist where interdependencies between the companies are such that it is appropriate to consider them associated.

The purpose of the new rules is to take the existence of other companies into account for the purposes of the small companies' rate where there is a substantive relationship between the relevant companies but not where any 'association' is an accident of circumstance, including circumstance of family relationships that do not extend into business.

Note that the new rules apply only to the attribution of rights held by associates of participators. Rights held by the participators themselves are always taken into account, whether or not there is any fragmentation.

In the rest of this guidance 'fragmentation' includes both situations where the activities of an existing business, which has been carried on by a single company, are split up between two or more companies, and situations where economic activities, which form an economic whole or are financially, economically or organisationally interdependent, are carried on by more than one company. The latter applies to existing activities and to new activities undertaken by an existing company or related companies.

When considering whether there has been any fragmentation, you should have regard to the degree of financial, economic or organisational links which exist, or have existed, or might be expected to exist between the relevant activities/companies involved. See CTM03785, CTM03790 and CTM03795.

Each case will depend on its specific circumstances. The examples in CTM03785, CTM03790 and CTM03795 illustrate the types of factor indicative of the necessary links between separate companies that are controlled by associated persons, although there will be many others.

For fragmentation to exist it is not necessary for all three types of link to exist. For example, if there is a sufficient financial link, one company will be an associated company of another even if no economic or organisational links exist.



However, even if fragmentation is not present, two companies may still be associated. For example, a husband and wife separately own the shares in and run two completely different and separate companies, but the husband is guarantor of a loan to his wife's company and as part of that guarantee is entitled to the company's assets if it is wound up. The two companies will be associated, not through the focus of the fragmentation rules – attribution of associates' rights – but because the husband will control both companies through his shareholding and rights to assets on winding up.

### **CTM03785 – Fragmentation – Financial links**

A business is unable to operate without the necessary funds and financial backing to do so. Signs of financial interdependence include:

- Financial support given by one company, or its owner(s) to another company/companies. The company would not be viable without support from the other(s). The support may be directly to the company concerned or indirect in, for instance, the form of guarantees or cross-guarantees.
- The separate companies share a common financial interest in the affairs of a business.

Where more than one business activity is operated from the same or adjoining premises, and the existence of one guarantees or underpins the viability of the other, the companies should be considered to be associated.

### **Examples**

R is the major shareholder and director of Company D which provides IT consultancy services. His son, S, is the major shareholder and director of Company E which provides business management services. R provided, as a family matter rather than for business reasons, a personal guarantee in respect of a bank loan made to Company E when S set up the business. The two companies are controlled by associated individuals but there is no financial (or other) link between the companies because the guarantee has been given by R in his personal capacity and this financial support has no link to Company D. The companies are therefore not associated. If, however, R had given additional security over the assets of Company D in support of the loan to Company E, there would be a financial link between the two businesses, which would cause the companies to be 'associated'.

X is the sole shareholder and director of Company A and a 49 per cent shareholder in Company B which operates from the same sets of premises. Company A runs a chain of ice cream parlours and a fleet of ice cream vans, and Company B manufactures and sells ice cream. Company A has provided collateral for a loan taken out by Company B to buy ice cream-making equipment. No cross-charge is made by Company A in respect of shared overheads (rent, electricity, telephone). If Company A folded, Company B would not be able to continue to trade. Company B is unable to operate without the financial support provided by Company A. The two companies are in fact operating a single business and are 'associated'.

C is the major shareholder in Company Y and a 49 per cent shareholder in Company Z. The two companies operate a large public house, which is very popular for family dining as well as having a thriving wet trade. Company Y handles wet sales and Company Z, which is run by the majority shareholder, C's wife, manages the catering operation. Mrs C has financed the purchase of the assets of the catering business from a family legacy and a loan to Company Z which she is guaranteeing personally. Both businesses are insured separately. Each business fully meets its own costs, and the catering business is charged a commercial rate for the use of the shared premises, employees and facilities. Although there is no cross subsidy, the two companies share a common economic goal and premises, and Company Z would not be viable without Company Y. The two companies are accordingly 'associated'.

L is the major shareholder and director of Company M, a large road haulage company. His son P is the sole shareholder in Company Q, a business distributing DVDs, which P has built up from scratch and runs with his wife. The premises occupied by Company Q are owned by L but Company Q pays a market rent for them. The two companies are controlled by associated individuals but there is no financial (or other) link between the companies. L has never had any involvement with Company Q, and P has never had any involvement in Company M. There is no fragmentation of control and the companies are not 'associated'.

### **CTM03790 – Fragmentation – Economic links**

Where there are direct and economic links between companies, it may be appropriate to treat them to be associated. Indicators include:

- Separate companies are seeking to realise the same economic objective.
- The activities of one company benefiting the other company/companies.
- Separate companies supplying the same circle of customers.

### **Examples**

A and B are brothers who have developed successful internet businesses from modest beginnings when sharing a flat together as students studying computer science. Right from the start both were very interested in the business possibilities of web site design. A is the major shareholder and director of Company P which provides professional web design services, and B is the major director and shareholder of Company Q which provides graphic design services. Although their developing businesses have benefited from the mutual exchange of ideas, especially in the early days, the brothers have had no other involvement in each other's businesses, which operate entirely independently. The link between the two companies is too tenuous to make them 'associated'.

P is the major shareholder in Company A. His wife is the major shareholder in Company B. Company A operates a wholesaling business and Company B is a retailer. Company B is Company A's sole customer. The two companies share the same economic objectives and are therefore treated as being 'associated'.

Q is the major shareholder in Company C which runs a very large Chinese restaurant in Soho. Company C also sells foodstuffs in a Chinese supermarket backed by its reputation as a restaurant. Mrs Q, who is a chef trained in France, is the sole shareholder in Company D which runs a gastronomically starred restaurant she has built up from scratch in Mayfair. Company D also imports delicacies from all over the world for sale on the internet, again backed by its reputation as a restaurant. Although Q and Mrs Q are husband and wife, and in the same trade, there is no link between their two companies, which have been trading since well before they knew each other. Their activities are not 'associated'.

M is the major shareholder in Company R, a dry cleaning business. Mrs M has opened a second dry cleaning business at the other end of the town. This is run by Company S, of which she is the sole shareholder. Company S offers specialist services in relation to wedding and evening dresses in addition to the normal range of dry cleaning facilities. Company R acts as agent for these specialist services which it does not have the ability to supply itself. In substance, Company S is an extension of Company R's business. The companies are therefore regarded as being 'associated'.

## CTM03795 – Fragmentation – Organisational links

Where there are direct and immediate organisational links between separate companies, such that they could not reasonably be run by a third party at arm's length from the other(s), they may be parts of a single enterprise. Look for:

- Common management.
- Common employees.
- Common premises.
- Common equipment.

### Examples

X is the director and sole shareholder of Company R which operates a chain of laundrettes. His wife also runs a laundrette business through Company S. Although the two companies are in the same line of business, there are no links between them and they operate entirely independently – X and Mrs X started their individual businesses long before they met and they have kept the two enterprises entirely separate. The two companies are operated by associated individuals but there is no link between them, and they are not 'associated'.

Y is the director and sole shareholder of Company L which operates a chain of laundrettes. The company has been in business for over twenty years. Five years ago he married Mrs Y, who has been helping him since their marriage in the running of the business. Two years ago, she opened her own laundrette which she operates through Company M. Company L has given security over its own assets in support of a bank loan to Company M. There is an organisational and a financial link between the two businesses, which causes them to be 'associated'.

Y is the director and sole shareholder of Company A and Mrs Y is the major shareholder in Company B. The two companies operate a chain of hairdressing salons. Company A provides hairdressing services and Company B provides hairdressing products. Company A rents all the premises, employs the stylists and receptionists, and pays all the bills. There is no cross charge for the use of facilities. Credit card payments are accepted by the salons. The electronic swipe machines are in the name of Company A. There is a single bank account to which the swipe machines are attached. At the end of each day the bankings are split between the two companies and transferred to their main bank current accounts. The accounts of the two companies do not truly reflect the situation of the businesses but are just an artificial division. In substance, the two companies are part of a single organisation – there is just the one business.

Z is the director and sole shareholder of Company P. He and his son are directors of Company Q, and each owns 50 per cent of the shares. Companies P and Q run a builders' yard selling wholesale to the building trade and retail to the public from the same premises, which Z owns. Company P is the trade wholesaler and has a 'trade only' counter; Company Q sells retail at a counter with its own access and parking in the yard. Company P's buyer buys stock for both the wholesale and retail side but the product ranges, stocking levels and prices are different. There are separate phone lines for the wholesaler and retailer. Z charges Company P a commercial rental. At the end of each week Company P invoices Company Q for goods supplied at cost plus a small mark-up. There is a proportionate division of overhead costs and Company P invoices Q an additional charge for other facilities. Wages for common employees are split in proportion between the two businesses. There are separate sale terms and tills for the businesses and they operate separate bank accounts and credit and credit card facilities. Each business has its own vehicles and the costs are kept strictly separate.

Where several business activities are operated from the same or adjoining premises, and the existence of one underpins the viability of the other, it is likely that they will be treated as associates. In this case, however, while the two companies operate at arms length, there are

significant organisational and economic links such that the retail business could not operate without the wholesale side. Accordingly, it is appropriate to treat them as 'associated'.

### **CTM03800 – Fragmentation – What HMRC do not consider to be fragmentation**

In determining 'control' for the purposes of ICTA88/s13(4), the attribution of rights held by associates is not intended to apply where there is an 'accident of circumstance' but rather on whether there has been in a real sense a 'fragmentation' of business activities. Each case will depend on its specific circumstances but there is no fragmentation of control in situations where

- Separate companies are controlled by associated persons but have no financial, organisational or economic links; and
- The associated persons have not, and never have had, involvement in the affairs of the companies controlled by the other associated persons.

# D

## Impact Assessment

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The Impact Assessment follows overleaf.

## Summary: Intervention & Options

<b>Department /Agency:</b> HMRC/HMT	<b>Title:</b> Reform of the Associated Company Rules as they apply to the Small Companies' Rate of Corporation Tax	
<b>Stage:</b> Consultation	<b>Version:</b> 1.0	<b>Date:</b> 23 October 2009
<b>Related Publications:</b>		

**Available to view or download at:**

[http://www.hm-treasury.gov.uk/consult\\_index.htm](http://www.hm-treasury.gov.uk/consult_index.htm)

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**What is the problem under consideration? Why is government intervention necessary?**

The existing rules that establish who controls a company and thus which companies are associated with each other are long-standing. However, certain aspects of the current rules (that attribute rights held by associates) operate in an automatic manner with no ability to consider the facts of each individual case.

**What are the policy objectives and the intended effects?**

The Government's aim for reform of the existing rules is to provide a test that retains those aspects of the test that work well within a new test that attributes rights only in circumstances where links between the companies involved make it appropriate to do so. Put broadly the new test seeks to ensure that companies cannot be associated by an attribution of rights by mere 'accident of circumstance'.

**What policy options have been considered? Please justify any preferred option.**

Option 1 – introduce a new fragmentation test that objectively tests whether companies are deemed to be associated for the purpose of access to the small companies' rate of corporation tax.  
Option 2 – retain the current automatic test.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?**

The policy would be reviewed within three years of a reform being introduced.

**Ministerial Sign-off** For Consultation Stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:



Date: 26 October 2009

## Summary: Analysis & Evidence

<b>Policy Option: 1</b>	<b>Description: Introduce a new fragmentation test</b>
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<b>COSTS</b>	<b>ANNUAL COSTS</b>	Description and scale of <b>key monetised costs</b> by 'main affected groups' The 'negligible' cost reflects the small pool of affected companies and the minor role that attribution of rights play in the process of establishing which companies are associated. The consultation paper asks for respondents' views on these costs.
	<b>One-off (Transition)</b> Yrs	
	<b>£ negligible</b>	
	<b>Average Annual Cost</b> (excluding one-off)	
	<b>£ nil</b>	
<b>Total Cost (PV)</b>		<b>£ negligible</b>
Other <b>key non-monetised costs</b> by 'main affected groups' None		

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>	Description and scale of <b>key monetised benefits</b> by 'main affected groups' The 'negligible' benefit reflects the small pool of affected companies and the minor role that attribution of rights play in the process of establishing which companies are associated. The consultation paper asks for respondents' views on these benefits.
	<b>One-off</b> Yrs	
	<b>£ nil</b>	
	<b>Average Annual Benefit</b> (excluding one-off)	
	<b>£ negligible</b>	
<b>Total Benefit (PV)</b>		<b>£ negligible</b>
Other <b>key non-monetised benefits</b> by 'main affected groups' None		

<b>Key Assumptions/Sensitivities/Risks</b> It is estimated that there would be a negligible exchequer cost.
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Price Base 2009	Time Period Lifetime of Measure	<b>Net Benefit Range (NPV)</b> <b>£ negligible</b>	<b>NET BENEFIT (NPV Best estimate)</b> <b>£ negligible</b>
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What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	To be determined
Which organisation(s) will enforce the policy?	HMRC
What is the total annual cost of enforcement for these organisations?	£ nil
Does enforcement comply with Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	N/A
What is the value of the proposed offsetting measure per year?	£ not applicable
What is the value of changes in greenhouse gas emissions?	£ not applicable
Will the proposal have a significant impact on competition?	No
Annual cost (£-£) per organisation (excluding one-off)	Micro nil    Small nil    Medium nil    Large nil
Are any of these organisations exempt?	No    No    N/A    N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)		(Increase - Decrease)
Increase of    £ nil	Decrease of    £ negligible	<b>Net Impact</b> £ negligible

Key:    Annual costs and benefits: Constant Prices    (Net) Present Value

## Evidence Base (for summary sheets)

### **Background**

As part of the Related Companies Simplification Review, HM Treasury and HM Revenue & Customs (HMRC) are working in partnership with business to identify options for reform of the associated company rules as they apply to the small companies' rate of corporation tax (SCR), a lower rate of corporation tax for companies with profits below £300,000.

The rules establish who controls a company and thus which companies are associated for the purpose of access to the SCR. Where a company is deemed to be associated with other companies the corporation tax thresholds are reduced accordingly. For example, if a company is associated with two other companies the threshold for access to the SCR will be reduced from £300,000 to £100,000 and the threshold for marginal relief will be reduced from £1.5 million to £500,000. Broadly, the effect is to adjust the rate of tax to take account of all the profits of associated companies, meeting the Government's policy aim of ensuring that each associated company's tax rate reflects it being a fragment of a wider economic unit.

An initial modification of the existing rules where a director or shareholder is separately in a partnership was introduced at Budget 2008. Since then the Government has continued discussions with representative bodies and tax advisers to identify how the rules could be further reformed to simplify the legislation and ensure that they best meet their intended purpose. Based on these discussions, the Government is now consulting on a proposal for further reform of the rules.

### **Objective**

The existing rules that establish which companies are associated with each other are long-standing. However, aspects of the rules do not objectively test whether companies controlled by different people/persons are fragments of a wider economic whole as a result of the interdependencies between them. Current rules that attribute rights held by associates take no account of whether a business, or control over it, has been: deliberately fragmented to access a lower rate of tax or developed in separate but linked companies; or developed entirely independently by linked individuals. Rather they look to mechanical rules that apply regardless of the wider circumstances.

The Government has previously recognised that aspects of the current rules can apply to companies in a manner unintended by the policy objective. Therefore, in addition to simplifying the legislation, the proposed reform seeks to ensure that companies are not treated as being associated by virtue of an attribution of rights where there are insufficient links between the companies to warrant it, so as to ensure that the tax outcome reflects the economic and commercial reality.

In accordance with these aims, the objective for the new fragmentation test is 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. Put broadly, the new test seeks to ensure that companies cannot be associated by an attribution of rights by mere 'accident of circumstance'.

### **Options**

Following the launch of the Related Companies Simplification Review at the 2007 Pre-Budget Report, the Government published an online survey on the Corporation Tax rules for related companies. Over 140 responses were received, which came from a range of interested parties, including professional advisers and representative groups. Since then the Government has continued to consult informally with a number of representative bodies and tax advisers to discuss the key issues with the current rules and identify options for reform. On the basis of these discussions, the Government has brought forward an option for reform of the rules.



**Option 1 – New fragmentation test.** The proposed test follows the approach taken by both the Finance Act 2008 amendments to the SCR fragmentation rules and Extra Statutory Concession C9, in seeking to ensure rights held are only attributed between linked persons where links between the companies are sufficient to consider them interdependent and thus fragments of a wider whole. In establishing whether companies are deemed to be associated, regard would be had for the level of economic, financial and organisational interdependence that exists between the relevant companies. The proposed new test and accompanying guidance can be seen in its entirety in the consultation document of which this Impact Assessment is a part.

**Option 2 – Retain the current automatic test.**

### **Evidence base**

It is not possible to precisely determine the population which would be affected by the proposed change. In particular the CT600 (company tax return) for any company records only the number of companies associated with it but not which they are. Therefore, to estimate the potential population affected we have matched records of directors' names and addresses, which are then matched to CT600 records. From this we have estimated a total population of 40 thousand companies linked through the immediate family living at a single address.

We have assumed that one-fifth of these would be ineligible since the operations of the linked companies are not truly independent of each other so would still be deemed associated. This leaves us with an eligible pool of 30 thousand companies.

Of the eligible pool the vast majority (85 per cent or 25 thousand) are already paying at SCR – so there would be no impact on them in terms of the rate of Corporation Tax to be applied – leaving a maximum of 5 thousand which would receive benefit from paying at a lower rate.

Finally we have assumed that the impact of the recession would be to a) reduce the number making any profits and b) reduce the amount of profits of those which are still making a profit. Combined we estimate that this would reduce the pool of beneficiaries to 3 thousand companies.

### **Costs and benefits**

#### **Benefits**

The reform would remove some companies from the scope of the rules, with up to 3 thousand companies directly benefiting through paying a lower rate of tax as a result of being able to access the SCR or marginal relief. In addition, the reform would help to ensure fair tax treatment between taxpayers and remove distortions to commercial decision making by ensuring that economic outcomes and tax outcomes are more closely matched.

The change would have a negligible impact on admin burdens.

#### **Costs**

The reform would impose a negligible one-off cost on companies as a result of the need for familiarisation with the new rules. This would fall mainly on those where companies are run separately within the household, where consideration would have to be given as to whether those are truly economically, financially and organisationally independent. We have assumed that this would take at most 20 minutes but since the population is so small the total cost would be negligible. It is not expected the reform would impose any ongoing costs.

#### **Tax yield**

The reform would mean that up to 3 thousand companies would pay a lower rate of tax through being able to access the SCR or marginal relief. It would therefore have a small Exchequer cost.

### **Specific impact tests**

#### **Competition assessment**

The reform would not be expected to have any adverse impacts on competition, as it would not: directly or indirectly limit the number or range of suppliers; limit the ability of suppliers to compete; or reduce suppliers' incentives to compete vigorously.

### **Small firms impact test**

The reform would not be expected to have any adverse impacts on small firms since it carries negligible admin burden consequences and there are no circumstances in which it can cause the rate of tax applied to a company to increase.

### **Legal aid**

The reform would have no impacts on legal aid and no new criminal or civil sanctions would be introduced.

### **Sustainable development**

The reform would not be expected to have any impact on the five principles of sustainable development, which are: living within environmental limits; ensuring a strong, healthy and just society; achieving a sustainable economy; promoting good governance; and using sound science responsibly.

### **Carbon assessment**

The reform would not be expected to have any impact on greenhouse gas emissions.

### **Other environment**

The reform would not be expected to have any impact on waste management, air quality, the appearance of landscape or townscape, habitat and wildlife, noise levels or any other environmental factor.

### **Health**

The reform would not be expected to have an impact on health, well-being or health inequalities.

### **Race, disability and gender equality**

The reform would have no negative impacts in these areas.

### **Human rights**

The reform would not be expected to affect human rights.

### **Rural proofing**

The reform would not be expected to have a different impact in rural areas.

## Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No









## HM Treasury contacts

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