RELEVANT TO ACCA QUALIFICATION PAPER P6 (UK) AND PERFORMANCE OBJECTIVES 19 AND 20

Corporation tax, part 1

This is the Finance Act 2011 version of this article. It is relevant for candidates sitting the Paper P6 (UK) exam in 2012. Candidates sitting Paper P6 (UK) in 2013 should refer to the Finance Act 2012 version of this article, to be published on the ACCA website in 2013.

This article follows a company as it begins trading, acquires an additional business, and eventually invests overseas. It sets out the commercial decisions taken by the company and its shareholders at the different stages in the company's development and summarises the tax implications of those decisions. After reading each of the three stages in the company's development, stop and think about the possible tax implications before reading on.

Early years
Kai Milford and his friend, Fay Dusky, formed Global Figurines Ltd (GFL) on 1 April 2010. Kai and Fay each acquired 40% of the company at a cost of £100,000. Kai used a recent inheritance to acquire the shares whereas Fay took out a bank loan for £100,000 secured on her house. The remaining 20% of the shares is owned equally by four of their friends.

GFL manufactures resin models of historic figures and advertises them for sale to the public in magazines and on its website. Kai and Fay work full time in the management of the company. The other shareholders are passive investors.

GFL incurred significant start-up costs during the year ended 31 March 2011. As a result, its taxable total profits, after paying salaries to Kai and Fay, were only £60,000. GFL made a loan of £14,000 to Lamar, one of the passive investors, on 1 December 2010.

The tax implications arising out of these events are:

- The interest paid by Fay on the loan to acquire the shares in GFL is qualifying deductible interest. This is because GFL is a close company (it is controlled by Kai and Fay – ie by fewer than five shareholders) and Fay works full time for the company. Qualifying deductible interest is a tax-allowable payment that is deducted in arriving at Fay's net taxable income.
- GFL is a close company and has made a loan to a participator, Lamar. Accordingly, GFL should have paid HM Revenue & Customs (HMRC) £3,500 (25% of the loan) by 1 January 2012 (ie nine months and one day after the end of the accounting period). HMRC will repay the £3,500

when the loan is repaid by Lamar or waived by GFL. GFL would not have had to make any payment if Lamar had worked full time for the company as the loan is for less than £15,000 and Lamar does not own more than 5% of GFL.

- GFL's corporation tax liability for the year ended 31 March 2011 would have been £12,600 (£60,000 x 21%).

Expansion via acquisition
In February 2011 Fay identified TP Ltd (TPL) as a possible acquisition. TPL manufactures figurines of painters and poets and was a member of a large group of companies. It was agreed (for commercial reasons) that the trade and assets of TPL, rather than the shares, would be acquired.

On 1 April 2011, GFL formed a wholly owned subsidiary called Writers and Artists Ltd (WAL). On the same day, WAL acquired the trade and assets of TPL. TPL had trading losses of £65,000 and capital losses of £18,000 available to carry forward as at 31 March 2011.

The results of the two companies for the year ended 31 March 2012 were as follows:

GFL	Taxable total profits	£200,000
WAL	Trading profits	£80,000
	Chargeable gains	£20,000

The tax implications arising out of the expansion via acquisition are:

- The capital losses of TPL will remain with TPL. TPL has sold its trade and assets to WAL and capital losses always remain with a company when it sells its trade. TPL can use its capital losses to relieve any chargeable gains arising on the assets sold to WAL.
- The trading losses of TPL will also remain with TPL and will not be transferred with the trade. Where a company sells its trade to an unconnected company, any trading losses remain with the vendor company. TPL may be able to offset the losses against any capital allowance balancing charges arising on the sale.
  It is possible for trading losses to be transferred to the purchaser when a company sells its trade to another company, but only when certain conditions are satisfied. Broadly, the same persons must beneficially own at least 75% of the business both before and after the sale. These conditions would have been satisfied if TPL had formed a subsidiary, Newco, sold its trade to Newco, and then sold Newco to GFL.
  TPL is the legal and beneficial owner of its trade prior to the sale. If the trade had been sold to Newco, TPL would no longer be the legal owner of the trade but would still be the beneficial owner as it owns Newco, which

in turn owns the trade. In such circumstances the trading losses would be transferred to Newco together with the trade. This would enable Newco to use the trading losses against future trading profits arising from the same trade.

However, because there has been a change in the ownership of Newco (it has been sold by TPL to GFL), if there is a major change in the nature or conduct of Newco's trade within three years of the purchase by GFL, it would not be possible for the losses to be carried forward beyond the date of the change of ownership of Newco.

- There are now two companies in the GFL group. Accordingly, the limits used to determine the rate of corporation tax payable must be divided by two.

  The corporation tax liability of the group for the year ended 31 March 2012 is computed as follows:

GFL	**£**
£200,000 x 26%	52,000
Less: marginal relief	
(£750,000 – £200,000) x 3/200	(8,250)
	43,750

WAL	**£**
£100,000 (£80,000 + £20,000) x 20%	20,000
Group tax liability (£43,750 + £20,000)	63,750

From a tax point of view, consideration could have been given to GFL acquiring the trade of TPL without the use of a separate subsidiary. This would have resulted in a single company with taxable total profits of £300,000 (£200,000 + £100,000) and a lower tax liability as set out below.

GFL (owning the trade of TPL)	**£**
£300,000 x 20%	£60,000
Reduced tax liability (£63,750 – £60,000)	£3,750

The decision as to whether or not to use a separate subsidiary would also need to take account of commercial and legal issues particularly in view of the relatively modest reduction in the total tax liability.

Going global

GFL's business has grown considerably and it expects to have taxable total profits of £800,000 in the year ended 31 March 2013. WAL is expected to have taxable total profits of £100,000 in the same period. Kai and Fay have been looking to expand overseas in order to take advantage of cheaper labour and manufacturing costs. They started a new manufacturing business in Marineland on 1 April 2012.

It is anticipated that the overseas business will make a trading loss of £60,000 in the year ended 31 March 2013, a profit of £80,000 in the year ended 31 March 2014, and a profit of £100,000 per year in future years.

The system of corporation tax in Marineland is broadly the same as that in the UK, although loss relief is only available to companies resident in Marineland. In addition, the rate of corporation tax is 50% regardless of the level of profits, and there is no withholding tax when dividends are paid to overseas shareholders. Marineland is not a member of the European Union and there is no double tax treaty between the UK and Marineland.

The tax implications arising out of going global

The tax implications of the Marineland business depend on the legal structure used. From a tax point of view there are two distinct ways of establishing the business:

- It could be owned directly by GFL (or WAL). Under this option, the business would be an overseas permanent establishment of a UK resident company.
- GFL (or WAL) could incorporate a new subsidiary in Marineland to acquire the business. Under this option, the business would be owned by an overseas subsidiary of a UK resident company.

Overseas permanent establishment

A permanent establishment is not a separate legal entity but is an extension of the company that owns it. The profits or losses of the permanent establishment belong directly to the company. Provided the permanent establishment is controlled from the UK, the trading loss made in the year ended 31 March 2013 could be offset by GFL (or WAL) against its income and gains of that year, thereby reducing the company's UK corporation tax liability. Once the permanent establishment is profitable, the company owning the permanent establishment will be subject to 50% Marineland corporation tax on the profits of the permanent establishment because it is trading within the boundaries of Marineland.

The profits will also be subject to UK corporation tax because a UK resident company is subject to tax on its worldwide income and gains. However, the UK corporation tax liability in respect of the profits of the permanent establishment will be fully relieved by double tax relief, as the rate of corporation tax in Marineland is higher than that in the UK. Accordingly, there will be no UK corporation tax to pay on the overseas profits.

The Finance Act 2011 introduced rules that enable a company to elect to exclude the profits and losses of its foreign permanent establishments from UK corporation tax. However, because the introduction of the rules was delayed, they are not examinable at the June or December 2012 sittings.

Overseas subsidiary
A subsidiary is a separate legal entity. A company incorporated in Marineland will be resident in Marineland for tax purposes provided it is not managed and controlled from the UK. Its profits or losses will then be subject to the tax regime of Marineland.

The trading loss of the year ended 31 March 2013 would be carried forward and deducted from the company's future trading profits arising out of the same trade. Once the company is profitable, it will be subject to tax in Marineland at the rate of 50%.

Any dividends paid to the UK parent company will be exempt from UK corporation tax.

Where a UK resident company acquires a company that is resident outside the UK the rules relating to controlled foreign companies (CFCs) should be considered. A CFC is a company that is:

- resident outside the UK, and
- controlled by persons resident in the UK, and
- subject to a level of taxation in the country in which it is resident that is less than three quarters of the amount that would have been payable had the company been resident in the UK.

The rate of corporation tax in Marineland is 50% so a subsidiary resident there would not be a CFC.

If the rate of corporation tax in Marineland had been considerably lower such that the corporation tax liability in Marineland could be less than three quarters of the equivalent UK liability it would have been necessary to consider the application of the CFC rules.
Where the rules apply, the profits of the CFC (income, not gains) are apportioned to those UK resident companies that are entitled to at least 25% of those profits. This apportionment requires the UK companies to include corporation tax at the main rate on the apportioned profits in their corporation tax returns.

No such apportionment is necessary where one of the exemptions applies. The most important exemptions are where:

- the accounting profits of the CFC do not exceed £200,000 in a 12-month period
- the taxable profits of the CFC do not exceed £50,000 in a 12-month period
- the CFC has a real presence in the country of residence in the form of staff and premises and its main activity does not consist of leasing, dealing in securities or the receipt of dividends, interest or royalties
- the reduction in UK tax caused by the existence of the CFC was not the main reason for the existence of the CFC
- the CFC carries on a trade and not more than 10% of its gross income is derived from persons within the charge to UK tax.

It is possible to obtain confirmation from HM Revenue & Customs regarding the application of the controlled foreign company rules including the availability of the exemptions.

When answering a question in the exam, any reference to CFCs (or any other technical issue for that matter) must be in accordance with the requirements and the facts of the question. Accordingly, if the question concerned the proposed investment in Marineland as set out above, the consideration of CFCs should be brief as, due to the rate of corporation tax, any subsidiary in Marineland will not be a CFC; there would be no need to explain what would happen if the company were a CFC or to set out the exemptions that are available.

Considering the facts of the proposed investment in Marineland
It is usually suggested that a permanent establishment should be used where an overseas enterprise is expected to make initial losses. This strategy enables the losses to be offset against any other profits of the company. However, the particular facts of the situation must be considered carefully.

The use of a permanent establishment in Marineland will enable GFL (or WAL) to offset the losses against its profits for the year ended 31 March 2013. This will save UK corporation tax at a maximum rate of 27.5% (where the company has profits between the limits).

The use of a subsidiary would mean that the losses could not be offset in the year ended 31 March 2013 as the subsidiary will not have any other income. However, in the following year the losses will reduce that year's profits and save tax in Marineland at 50%. Accordingly, provided the group is willing to wait for a year (from a cash flow point of view), a greater tax saving can be achieved by using a subsidiary in Marineland rather than a permanent establishment. This assumes, of course, that the anticipated profits materialise in the year ended 31 March 2014.

It must also be recognised that a subsidiary is an associate for the purpose of determining the rate of tax paid by group companies whereas a permanent establishment is not. Accordingly, the use of a subsidiary (rather than a permanent establishment) could increase the rate of corporation tax paid by the UK companies. However, on the facts given, whether a permanent establishment or a subsidiary is used makes no difference to the liabilities of the UK companies in the year ended 31 March 2013.

Conclusion
The formation, expansion, and overseas development of the GFL group highlight the following issues.

- It is always important to identify whether or not a company is a close company. It is then necessary to consider the facts of the situation in order to determine which, if any, of the implications of a company being close are relevant.
- When a company purchases a new business it should consider whether to own the business directly or via a new subsidiary. The structure used may affect the total tax liability of the group.
- Where a company acquires the trade of another company, capital losses remain with the vendor company. Trading losses will also remain with the vendor company unless the two companies are under common ownership.
- It is usually beneficial to use an overseas permanent establishment when a business is expected to make losses. However, the facts given should always be considered carefully, as it may be possible to obtain more tax relief overseas than in the UK.

The corporation tax issues relating to groups are considered in two further articles: Corporation tax and groups for Paper P6 (UK) Part 1 – Group relief, and Part 2 – Capital gains groups.

Rory Fish is examiner for Paper P6 (UK)