

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

Corporation tax and groups – group relief

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 is the first of two articles on corporation tax and groups. The second covers groups and chargeable gains.

Groups of companies are an important aspect of corporation tax within paper P6 (UK). Having studied the basics of this area at Paper F6, you are now expected to progress to more advanced aspects. However, the basic rules continue to be of vital importance as they are the foundation on which the additional rules rest. You must have a sound knowledge of the many rules within this subject if you are to be able to handle an exam question involving groups.

This is not an introductory article; it is relevant to students coming to the end of their studies and finalising their preparations to sit the exam. It begins by briefly summarising the rules relating to both group relief groups and capital gains groups. It then goes on to consider a number of group relief tax planning issues that could be introduced in an exam question. It does not include comprehensive explanations of the rules but assumes a reasonable knowledge.

This article is intended to be read proactively – ie statements made should be confirmed as true by reference to the reader's understanding of the rules, or to a relevant study text. This approach will enable future situations to be analysed from first principles rather than by reference to a rigid set of memorised planning points. The tax rates and limits for financial year 2011, ending on 31 March 2012, are used throughout this article.

THE BASIC RULES

The structure of the H Ltd group of companies is set out in Figure 1. It should be assumed, at least to begin with, that all of the companies are resident in the UK. The minority shareholders in the group companies are companies with no relationship with H Ltd.

You should be able to review the group structure and confidently identify the members of any group relief groups and capital gains groups. Try to do this before you read the information in Table 1.

FIGURE 1: THE STRUCTURE OF THE H LTD GROUP OF COMPANIES

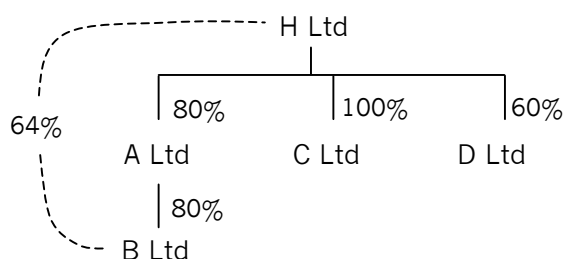


TABLE 1: GROUP RELIEF AND CAPITAL GAINS GROUPS RE FIGURE 1

	Group relief group	Capital gains group
The groups	<ul style="list-style-type: none"> • H Ltd, A Ltd and C Ltd form a group. • A Ltd and B Ltd form a separate group. 	<ul style="list-style-type: none"> • H Ltd, A Ltd, B Ltd and C Ltd form a single group.
Rationale	<ul style="list-style-type: none"> • B Ltd is not in a group with H Ltd because the effective interest of H Ltd in B Ltd is less than 75%. 	<p>B Ltd is in a group with H Ltd because:</p> <ul style="list-style-type: none"> • H Ltd has a direct interest in A Ltd of at least 75% and A Ltd has a direct interest in B Ltd of at least 75%, and • the effective interest of H Ltd in B Ltd is greater than 50%.

Once a group relief group exists, the following applies:

- Any company in the group can surrender current period trading losses, non-trading deficits on loan relationships, excess property business losses, excess management expenses, and excess gift aid donations to any other company in the group.
- The maximum surrender to a group company is that company's taxable total profits. For this purpose, a company's taxable total profits are reduced by its own trading losses for the current period regardless of whether or not such a loss claim is made.

Before you study the further issues set out below, consider the tax implications of making the following mutually exclusive changes to the H Ltd group structure.

1. B Ltd owns 90% of W Ltd.
2. Rather than H Ltd owning A Ltd, C Ltd and D Ltd, the owner is Mr H, a UK resident individual.

The implications are summarised at the end of this article.

TAX PLANNING ISSUES RELATING TO GROUP RELIEF

The remainder of this article examines the tax planning issues relating to group relief groups. Throughout this review of tax planning issues, the term 'losses' will be used to represent any/all tax attributes that can be surrendered via group relief.

Companies resident overseas

Companies resident overseas are included within a group relief group. However, losses can only be surrendered between companies that are resident in the UK or are resident overseas but have a permanent establishment in the UK. If the H Ltd group were owned by H Inc, a company resident and trading outside the UK and the European Union, rather than H Ltd, the members of the group relief groups would not change. However, losses could only be surrendered between A Ltd and C Ltd and between A Ltd and B Ltd.

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Planning the distribution of losses to members of the group

The value of a company's losses depends on how they are used. This value is maximised by offsetting the losses against those profits that would otherwise be taxed at the highest rate of tax. A company will pay tax at the main rate where its augmented profits (taxable total profits plus its franked investment) exceed the upper limit, at the lower small profits rate where they are less than the lower limit and at a rate in excess of the main rate on those profits between the lower and upper limits. Accordingly, the aim is to offset the losses against:

- profits between the limits, then
- profits in excess of the upper limit, then
- profits below the lower limit.

Most, if not all, students are aware of this strategy – but many misinterpret what it means and think that it is disadvantageous for a company to have profits between the limits. In fact, the opposite is true. Companies with profits between the limits pay a rate of tax in excess of the main rate only on the amount of profits between the limits and not on all of their profits. The overall effective rate of tax paid by such companies must, of course, be less than the main rate as the corporation tax liability is computed by charging tax at the main rate and then deducting marginal relief.

The implication of this is that it is *beneficial* to use losses to cause a company that would otherwise pay tax at the main rate to become a marginal company. This is illustrated in **Example 1**.

EXAMPLE 1

LC Ltd has taxable profits of £425,000 and no franked investment income. Its upper limit is £375,000 and its lower limit is £75,000. It will pay corporation tax on its profits of £110,500 (£425,000 x 26%) because its profits exceed the upper limit. When thinking about the company from the point of view of loss utilisation, it can be regarded as paying corporation tax at the following rates.

	£
On profits up to the lower limit (£75,000 x 20%)	15,000
On profits between the limits (£300,000 x 27.5%)	82,500
On the remainder (£50,000 x 26%)	<u>13,000</u>
Total liability	<u>110,500</u>

A group company is to surrender losses of £150,000 to LC Ltd. This will reduce its profits to £275,000 and cause the company to become a marginal company (a good thing) saving tax partly at the full rate and partly at the marginal rate. The corporation tax liability of LC Ltd will be calculated as follows:

	£
Corporation tax at the main rate (£275,000 x 26%)	71,500
Marginal relief ((£375,000 – £275,000) x 3/200)	<u>(1,500)</u>
Total liability	<u>70,000</u>

The losses will first relieve the profits taxed at the main rate (£50,000) and then £100,000 of the profits taxed at the marginal rate as set out below.

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	£
On profits above the upper limit (£50,000 x 26%)	13,000
On profits between the limits (£100,000 x 27.5%)	<u>27,500</u>
Total tax saved (£110,500 – £70,000)	<u>40,500</u>

The effective rate of tax saved in respect of the offset of the losses is 27% (£40,500/£150,000); a rate in excess of the full rate, for obvious reasons.

Associated companies

When determining the upper and lower limits of a particular company, watch out for the length of the accounting period and make sure you are confident of the definition of associated companies. All companies in the group relief group will be associates but so will other companies, including companies where the effective ownership is less than 75%, companies resident overseas, and companies controlled by the same individual(s), even though they are not in a group with the subject company. For example, in Figure 1, all five companies are associated with each other.

In addition, remember that companies need only be associated at some point in the accounting period and not for the whole of the accounting period. Accordingly, when determining the number of associated companies in relation to a company that has just joined a group, it is necessary to include any companies with which it was associated prior to the purchase (but during the same accounting period).

Consortia

As a general rule, before starting any calculations in the exam, make sure you have considered all of the possible options. When dealing with group loss planning, this means thinking about the possible existence of a consortium. In the group above, D Ltd is not a member of the H Ltd group relief group, but that does not necessarily mean that H Ltd cannot surrender losses to D Ltd; it depends on who owns the remainder of D Ltd's share capital. If companies that each own at least 5% together own at least 15% (such that they, together with H Ltd, own at least 75%), then D Ltd will be a consortium company. H Ltd would then be able to surrender losses to D Ltd up to a maximum of 60% of D Ltd's profits.

Group relief and the carry back of losses

Once a company has offset trading losses against its total profits of the current accounting period, it can elect to offset any remaining losses against its total profits of the previous 12 months. Unlike group relief, the offset of losses against a company's own total profits is an all or nothing claim such that, if there are sufficient losses, taxable profits will be reduced to zero. However, group relief can be used to engineer the carry back of a particular amount of losses in order to offset losses at the highest possible rates of tax as set out in Example 2.

EXAMPLE 2

In the year ended 31 March 2012, UL Ltd has a trading loss of £200,000 and no other income or gains. In the previous year its taxable profits were £235,000. Its upper limit is £375,000 and its lower limit is £75,000. The other members of its group relief group pay corporation tax at the full rate. UL Ltd has profits of £160,000 (£235,000 – £75,000) taxed at the marginal rate in the year ended 31 March 2011. In order to

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relieve its losses against these profits, while avoiding relieving any profits taxed at the small profits rate, UL Ltd will need to submit the following claims.

1. Before submitting a claim to carry back losses to the previous year, UL Ltd should surrender losses to other group companies where they will save tax at the main rate. UL Ltd wants to carry back losses of £160,000 and should therefore surrender losses of £40,000 (£200,000 – £160,000).
2. UL Ltd should then submit a claim to carry back its remaining losses against the profits of the previous year.

The additional corporation tax saved via the operation of this strategy, as opposed to a surrender of all of the losses to group companies, is £2,400 (£160,000 x (27.5% – 26%)).

Double tax relief

Any foreign tax available for offset against a company's corporation tax liability must be taken into account when planning the utilisation of losses. Sufficient overseas profits must remain subject to UK corporation tax in order to avoid wasting the double tax relief as set out in Example 3.

EXAMPLE 3

KT Ltd has taxable profits of £280,000 of which £80,000 has arisen overseas. The overseas tax on the overseas profits is £16,000. There are losses in the KT Ltd group relief group in excess of £280,000 and the intention is to reduce its UK corporation tax liability, after the deduction of double tax relief, to zero. All companies in the KT Ltd group pay corporation tax at the full rate.

KT Ltd will not waste any double tax relief if the UK corporation tax liability in respect of its overseas income equals the overseas tax suffered of £16,000. Accordingly, it needs to have taxable overseas profits of £61,538 (£16,000/26%) and to claim group relief of £218,462 (£280,000 – £61,538). Note that the company can choose to offset the group relief against its UK profits before its overseas profits. The company's final corporation tax computation is as follows:

	£
Taxable profits	280,000
Less: Group relief	(218,462)
Taxable total profits	<u>61,538</u>
Corporation tax at 26%	16,000
Less: Double tax relief	<u>(16,000)</u>
Corporation tax liability	<u>Nil</u>

Companies joining and leaving the group

You should pay close attention to any information in a question relating to the acquisition or disposal of group companies because group relief is restricted where a company is not a member of the group for the whole of the accounting period. For example, where a company is a member of a group for eight months, only eight months of its losses will be available for group relief. Similarly, only eight months of its profits can be relieved via losses from other group companies.

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A company joins a group when it is acquired. However, it leaves a group, for the purposes of group relief, when there are arrangements in force for it to leave the group – for example, once an agreement for the sale of the company has been reached between the parties subject to a contract being signed. This may well be some time before it is finally sold, such that there may be a gap between leaving one group and joining another. Losses arising in the gap period can only be relieved in the loss-making company, and their use may be restricted if there is a major change in the nature or conduct of the company's trade within three years of the date of the change of ownership.

CONCLUSION

When dealing with corporate losses, you should think about the possible reliefs in the loss-making company before addressing the group issues. This will ensure that you consider all of the possible options. When you come to deal with the group relief aspects of the question, your first task is to identify the members of the group. You should then watch out for any information in the question that introduces one or more of the above issues into the problem.

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TAX IMPLICATIONS

The tax implications of making the changes to the H Ltd group structure are:

(1). B Ltd and W Ltd would form a separate group relief group in addition to the groups already identified. W Ltd would not be in a group with A Ltd because the effective interest of A Ltd in W Ltd would be less than 75% ($80\% \times 90\% = 72\%$).

W Ltd would be in the H Ltd capital gains group (with A Ltd, B Ltd and C Ltd) because B Ltd would have a direct interest in W Ltd of at least 75% and the effective interest of H Ltd in W Ltd would be more than 50% ($80\% \times 80\% \times 90\% = 57.6\%$).

(2). A Ltd, C Ltd and D Ltd would no longer be in a corporate group. Accordingly, the only group relief group would be A Ltd and B Ltd. This would also be the only capital gains group.