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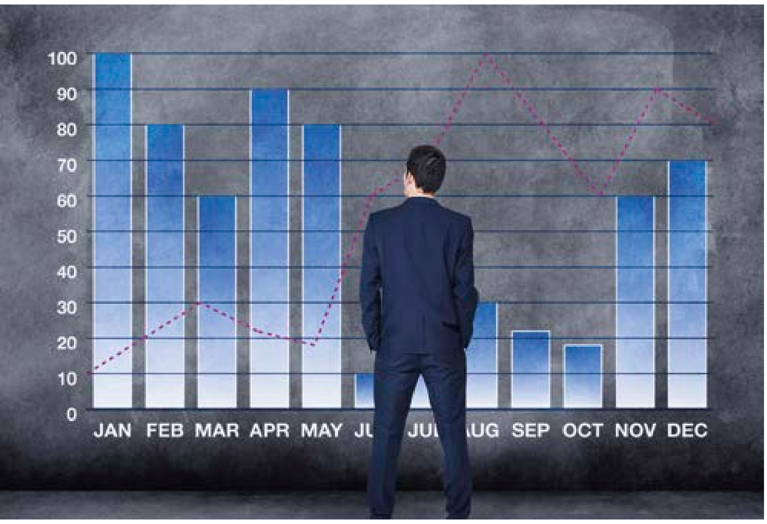
Corporation Tax – special rules for companies

When Corporation Tax was invented in 1965, the quantification of taxable profits bore a close resemblance to the taxation of the unincorporated business for many years. In more recent times the determination of profits has moved substantially from the original similarity and special rules have been introduced.

In this Briefing we review some of the special rules for companies.

Reliefs for trading losses

Loss reliefs seem to be an unusual place to start as companies are expected to make profits aren't they? However new reliefs are proposed (in autumn Finance Bill) for companies with losses arising from 1 April 2017, so this is why we are starting here. Also it is common for companies to generate losses through set up expenditure on new trades and/or additional investment in plant and machinery which provides an immediate tax write off with £200,000 of Annual Investment Allowance being available.



The loss reliefs available to companies are fairly generous if the company (or other companies in the same qualifying group of companies) have profits arising in the same accounting period in which the loss arises. Trading losses can be set against the company's profits of the period in which the loss arose, or surrendered as group relief in the same period.

A trading loss can be carried back against total profits of the previous 12 months. However, losses carried forward to a later period are more restricted.

Losses arising before 1 April 2017 can only be set against later profits of the same trade. Carried-forward amounts cannot be surrendered as group relief.

Losses arising from 1 April 2017, when carried forward, are given more flexibility and will be available for set-off against the total taxable profits of a company and its group members.

There is a potential sting in the tail for larger companies. From 1 April 2017, the new rules limit the amount of profit against which all carried-forward losses can be set to a maximum of 50% of the company's total profits for the period. However, each group, or a company that is not part of a group, will have an annual allowance of £5 million profits. Carried-forward losses can be set against that amount without restriction. The 50% restriction only applies to profits above the £5 million annual allowance.

Example

A company has the following expected results for the year to 31 March 2019 - trading profits £40,000 and property income £30,000. There is a trading loss brought forward of £60,000.

If this loss had been incurred pre 1 April 2017, only £40,000 would be capable of relief in 2019 against the trading profit and £20,000 would have to continue to be carried forward. If the trading loss has arisen post 1 April 2017, all of the loss can be relieved against profits in 2019.

Loan relationships

In the 1990s a trend developed to legislate specifically for the taxation of corporate profits. One area was the taxation of corporate debt. A loan made by a company to another entity or a loan granted to a company by a bank are examples of what are termed 'loan relationships'. The loan relationship regime removed the distinction between income and capital treatment for transactions involving debt. This is in marked contrast to the system that still applies to unincorporated businesses. Interest receipts and payments in such businesses are taxed as income or relieved against income. A loss made on a loan which is not repaid is however a 'capital' matter. Whether the loss gets any relief is a matter for the capital gains tax legislation.

The basic rules for loan relationships for companies are that:

- the tax system potentially recognises all debits and credits that arise from borrowing and lending
- the debits and credits will generally follow the accounting entries made for the purpose of the financial accounts

- trading items are dealt with as trading receipts or deductions
- non-trading items are taxed as net income from non-trading loan relationships with special rules for the relief of net non-trading deficits.

An example of a trading item for a company is a loan from a bank to provide finance for investment in plant to be used in the company's trade. If a company provides a loan to another company to help finance the other company's trade, this is likely to be a non-trading item.

Example
Co A lent to Co B £100,000 at an annual interest charge of £8,000 some years ago. Co A was keen to develop a relationship with Co B and has a minority stake in Co B. Co A typically makes annual profits of £80,000. In previous years the corporation tax treatment would have followed the entries in the annual accounts, namely: Co B - interest payable £8,000 – treated for tax as a trading expense. Co A - interest receivable £8,000 – treated for tax as non-trading income. In the current year, Co B has got into significant financial difficulties and is unable to pay the interest. Co A makes a full provision against the interest receivable and a £70,000 impairment of the loan. Co B will accrue for the interest payable of £8,000 – which will be treated for tax as a trading expense as in earlier years. Co A has no net income recognised in the accounts for the interest due to it and thus there will be no income for tax purposes. There will be a non-trading deficit of £70,000 in respect of the loan. This will be set off against the trading profits in that year.

One can see that this system does simplify the taxation of companies. However, over the years, the system has been complicated by legislation counteracting scenarios in which governments have perceived that the regime has been too generous in allowing relief for losses made on loans.

Two examples in which special rules may be applicable to small and medium sized businesses are:

- If a loan is made between connected companies tax relief for the writing down of a loan is generally not allowed. 'Connection' in this scenario means control of one company by another, or where both companies are under common control. Companies in a group are therefore connected as are two companies controlled by the same individual. So in the example above, Co A would not get relief for the £70,000 impairment.
- If a loan is made by a 'close' company (a company with five or fewer shareholders) to one of the shareholders and the company writes down the loan, specific legislation denies relief to the company in this instance.

Intangible assets

The taxation of intangible assets represents another area where the taxation treatment for companies moved away from a regime which still applies to unincorporated businesses. Intangible assets include such items as goodwill, trademarks and patents. Much of the expenditure on the acquisition of such items by businesses would represent capital expenditure and thus would not be deductible from trading income. Capital allowances were given for some items, for example patents, but other items, such as goodwill, were dealt with under the capital gains tax rules.

A company's acquisition of intangible assets from 1 April 2002 or created by the company from this date, is dealt with under one regime. In common with the principles of the loan relationship rules, taxable debits and credits follow the accounting entries made for the purpose of the financial accounts. Relief will be given for intangible fixed assets as the assets are written off (amortised) against profits.

Goodwill

Goodwill is one of the more common types of intangible expenditure by a company and may arise when a company acquires another business. In simple terms it is the difference between the purchase price of a business and the value of the tangible assets purchased and any other intangible assets. If a company has purchased the shares rather than the assets of another company, there will be no relief for the goodwill purchased as that is only reflected in the consolidated accounts of a group of companies and not in the accounts of the company which has purchased the shares of another company.

For purchases of goodwill before 8 July 2015, relief for the goodwill purchased was given when, and to the extent that, the goodwill was charged against profits. As the acquired business assets were likely to be used for the purpose of the company's trade, the amortisation reduced the trading profits of the company. If the company sells on the business in the future, the accounting profit will be taxed as trading income.

What about intangible assets acquired from 8 July 2015?

From 8 July 2015, a company acquiring a business is no longer able to claim a tax deduction until the goodwill is sold. If the goodwill is sold at a profit, this is generally taxed as trading income.

What about intangible assets acquired or created before 1 April 2002?

If a company acquired such assets before 1 April 2002, the assets remained outside the regime. The main practical effect of this rule, now that we are 15 years on from this date, is that if a company started a trade before 1 April 2002 and is now selling its trade, any amount(s) allocated to intangible assets will fall under the old taxation code (internally generated goodwill is deemed to have been created when the trade started). So, the sale of goodwill will fall to be taxed as a capital gain rather than trading profits.

Reinvestment relief

The intangible assets regime has a useful relief – called reinvestment relief – which can be used where the proceeds from the sale of an intangible asset are reinvested in a new intangible asset or assets. The relief is available where the proceeds on the sale of the old asset exceed the initial cost of that asset. The surplus is deducted from the acquisition cost of the new intangible assets. Thus there is no immediate tax charge on the element of the gain that is reinvested, but the result is that the sum available for future amortisation on the new asset is reduced. The expenditure on the replacement intangible assets has to be capitalised in the accounts.

The relief works in a similar way to a relief available on the sale of certain tangible capital assets of a company – called rollover relief. An example of a relevant tangible asset is freehold land. The gain which would otherwise be taxed as a capital gain can be rolled over against the acquisition cost of any other asset within the rollover relief regime.

What is not allowed is the deferral of corporation tax by reinvesting proceeds from the sale of an intangible asset into tangible assets and vice versa. They are two separate regimes.

How we can help

As can be seen from this summary, the corporation tax code is potentially complex. Please do contact us if you are considering significant transactions involving any of the above areas.