corporation tax

relevant to Professional Scheme Paper 3.2 (GBR)

development

This article follows a company as it begins trading, acquires an additional business, and eventually invests abroad.

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. It focuses, in particular, on those elements of corporation tax that are more likely to be examined at Paper 3.2 (GBR), rather than those included in the Paper 2.3 (GBR) syllabus.

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 2003. 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 first two years of trading. As a result, its profits chargeable to corporation tax, after paying salaries to Kai and Fay, were only £40,000 in each of the two years ended 31 March 2004 and 2005. GFL paid dividends of £12,000 in each of the first two years and made a loan of £14,000 to Lamar, one of the passive investors, on 1 December 2003.

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 annual interest. This is because GFL is a close company (it is controlled by Kai and Fay) and Fay works full-time for the company. Qualifying annual interest is an allowable charge on income that is deducted in arriving at Fay's statutory total income, and consequently reduces her 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 2005 (ie nine months 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 2004 would have been computed as follows:

	£
£40,000 x 19%	7,600
Less: marginal relief	
(£50,000 - £40,000) x 19/400	(475)
	7,125

In the following year, the corporation tax liability would initially be computed in the same way. However, rules introduced on 1 April 2004 impose an additional tax charge on companies that pay tax at less than 19% where dividends are paid to non-corporate shareholders. The effect of these rules is to tax the dividend paid to the non-corporate shareholder at 19%, while the balance of the taxable profits are taxed at the original effective rate of tax. Applying these rules to GFL results in the following liability for the year ended 31 March 2005:

	£
Original liability (as per the year ended 31 March 2004)	7,125
Effective rate of tax:	
7,125/40,000	17.8125%

	£
Tax on profits distributed to non-corporate shareholders:	
£12,000 x 19%	2,280
Tax on the remaining profits:	
(£40,000 - £12,000) x 17.8125%	4,987
	7,267

The additional tax liability of £142 (£7,267 - £7,125) is the non-corporate dividend of £12,000 multiplied by 1.1875% (19% - 17.8125%).

The non-corporate dividend rules were introduced as an anti-avoidance measure. Without them, it was possible for a company to make profits and distribute them to shareholders without giving rise to any tax liability. This is because there is no corporation tax where a company's profits do not exceed £10,000, and there is no income tax where dividends are received by a basic rate taxpayer. Consequently, before these rules were introduced, a sole trader with relatively low profits could incorporate and no longer pay tax on the profits of his business. The rules are designed to ensure that profits distributed to shareholders are taxed at a minimum of 19%. As a result, they only affect companies with an effective rate of tax of less than 19%.

EXPANSION VIA ACQUISITION

In February 2005, 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 2005, GFL formed a wholly owned subsidiary called Writers and Artists Ltd (WAL). On the same day, WAL acquired the trade and assets of TPL. As at 31 March 2005, TPL has trading losses available to carry forward of £65,000, and capital losses of £18,000. The results of the two companies for the year ended 31 March 2006 are as follows:

GFL	Profits chargeable to corporation tax	£200,000
WAL	Trading profits	£80,000
	Capital gains	£20,000

The tax implications arising out of expansion via acquisition are:

- The capital losses of TPL will remain with TPL. TPL has sold its trade and assets to GFL and capital losses always remain with a company when it sells its trade. TPL can use its capital losses to relieve any 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.

  In such circumstances, Newco could have used the trading losses against future trading profits arising from the same trade, provided there was no major change in the nature or conduct of its trade within three years of the purchase by GFL.
- 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 is computed as follows:

GFL	£
£200,000 x 30%	60,000
Less: marginal relief (£750,000 - £200,000) x 11/400	(15,125)
	44,875

WAL	£
£100,000 (£80,000 + £20,000) x 19%	19,000
Group tax liability (£44,875 + £19,000)	63,875

Consideration should 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 profits chargeable to corporation tax 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 19%	57,000
Reduction in tax liability (£63,875 - £57,000)	6,875

GOING GLOBAL

GFL's business has grown considerably and it expects to have taxable profits of £800,000 in the year ended 31 March 2007. WAL is expected to have taxable 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 intend to start a new manufacturing business in Marineland on 1 April 2006.

It is anticipated that the overseas business will make a trading loss of £60,000 in the year ended 31 March 2007, a profit of £80,000 in the year ended 31 March 2008, 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. There is no double tax treaty between the UK and Marineland.

The tax implications arising from going global are:

- 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, it would be an overseas branch of a UK resident company.

– GFL (or WAL) could incorporate a new subsidiary in Marineland to acquire the business. Under this option, it would be an overseas subsidiary of a UK resident company.

- **Overseas branch**
  A branch is not a separate legal entity but is an extension of the company that owns it. The profits or losses of the branch belong directly to the company.
  Provided the branch is controlled from the UK, the trading loss made in the year ended 31 March 2007 could be offset by GFL (or WAL) against its income and gains of that year, reducing the company's UK corporation tax liability. Once the branch is profitable, the company owning the branch will be subject to 50% Marineland corporation tax on the branch profits, because it is trading within the boundaries of Marineland from a permanent establishment.
  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 branch profits, 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 branch profits.
- **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 2007 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 grossed up, in respect of the underlying tax suffered in Marineland, and included in the parent company's profits chargeable to corporation tax. Double tax relief, at the lower of either the overseas tax suffered or the UK tax on the overseas income, is available. Accordingly, no UK tax will be due on the overseas dividends as the rate of tax in Marineland exceeds that in the UK.
- It is usually suggested that a branch 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 branch in Marineland will enable GFL (or WAL) to offset the losses against its profits for the year ended 31 March 2007. This will save UK corporation tax at a maximum rate of 30%.
  The use of a subsidiary would mean that the losses could not be offset in the year ended 31 March 2007, 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 branch. This assumes, of course, that the anticipated profits materialise in the year ended 31 March 2008.
  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 branch is not. Accordingly, the use of a subsidiary (rather than a branch) could increase the rate of corporation tax paid by the UK companies. However, on the facts given, whether a branch or a subsidiary is used makes no difference to the liabilities of the UK companies in the year ended 31 March 2007.

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

- It is always important to identify whether a company is a close company. It is then necessary to consider the facts of the situation in order to determine which of the implications of a company being close are relevant.
- Profits used by companies to pay non-corporate dividends are taxed at 19% where the company's effective tax rate is less than 19%.
- 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 branch when a business is expected to make losses. However, the facts given should always be considered carefully, as it may be possible to obtain greater tax relief overseas than in the UK. ■

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