Chartered Institute of Taxation
Excellence in Taxation

The Chartered Tax Adviser Examination

November 2012

Advanced Corporation Tax

Advisory Paper

Suggested Solutions

Answer 1

Icina Ltd

Corporation Tax computation for the year ended 31 December 2011

	Notes	£
Profit before tax		1,626,750
Add:		
Depreciation		8,127,579
Loss on disposal of fixed assets	2	870
Excess pension contributions	4	3,615,000
Deduct:		
Capital allowances		(4,147,780)
Dividends receivable	5	(420,000)
Profit on disposal of shares	6	(25,850)
Total taxable profits		**8,776,569**

Capital allowances computation for the year ended 31 December 2011

	AIA	*General pool*	*Expensive car*	*Special rate pool*	*Total CAs*
	£	£	£	£	£
TWDV b/f	0	20,567,898	17,000	0	
Additions:					
Car				26,000	
Ice rink	20,000				
Air con	10,000				
	30,000				
Disposal proceeds		(7,000)			
WDA 100%	30,000				30,000
WDA 20%		(4,112,180)			4,112,180
WDA restricted			(3,000)		3,000
WDA 10%				(2,600)	2,600
TWDV c/f		16,448,718	14,000	23,400	
					4,147,780

(1) A car park is specifically listed as not plant under List B.2 s22 CAA 2001. The air conditioning unit, being an integral feature, will qualify as plant (s33A(5)(c)). The ice rink has a function, since it is used to test equipment, rather than being part of the setting of the trade. So £30,000 qualifies as additions for the capital allowances pool attracting annual investment allowances ('AIA') at 100 percent.

(2) Icina Ltd made a loss of £870 from the disposal of fixtures. The net book value of those assets were £60,350 – £52,480 = £7,870. The disposal proceeds must have been £7,870 – £870 = £7,000.

(3) The new car has CO_2 emissions exceeding 160kg/km so it will be included in a special rate pool attracting writing down allowances at 10 percent.

(4) Excess pension contributions need to be spread in accordance with s197 FA 2004. In the last accounting period, the pension contributions were £3.8m. 210% × £3.8m = £7.98m. The £9m paid in this 12 month accounting period is more than £7.98m so s197 will apply. 110% × £3.8m = £4.18m. £9m – £4.18m = £4.82m. £4.82m is the relevant excess contributions and since this is more than £2m, one quarter of £4.82m (£1.205m) is deductible in this accounting period and in each of the next three accounting periods. Total amount deductible this year is therefore £4.18m + £1.205m = £5.385m, so £3.615m is to be added back.

(5) The dividend income of £420,000 from Vanna Ltd is an exempt distribution. There will be no double tax relief in respect of the overseas withholding tax. Chapter 3 rather than Chapter 2 of Part 9A CTA 2009 applies because Icina Ltd is not a small company (as defined at s931S CTA 2009). Article 2 of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 states that a small enterprise is defined as an enterprise which

employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million. S931D says that a dividend is exempt if it falls into an exempt class. Under s931E a dividend falls within an exempt class if the recipient controls the payer. The meaning of 'control' under s755D ICTA 1988 applies and this includes at subsection (1)(b) a situation where the recipient has the power to secure by virtue of the articles of association that the affairs of the payer are conducted in accordance with the recipient's wishes. So in this case, Icina Ltd controls Vanna Ltd.

(6) The profit arising from the disposal of shares in Armen Ltd comes within the substantial shareholding exemption at Schedule 7AC TCGA 1992 and is therefore not a chargeable gain. It is assumed that each of the companies is trading. A company holds a 'substantial shareholding' in another company if it holds not less than 10 percent of the company's ordinary share capital; and is beneficially entitled to not less than 10 percent of the profits available for distribution to equity holders of the company; and would be beneficially entitled on a winding up to not less than 10 percent of the assets of the company available for distribution to equity holders (paragraph 8 (1)). On its own Icina Ltd has only ever held 8 percent of the shares in Armen Ltd but it must take into account the 5 percent shareholding held by its wholly owned subsidiary, Itema Ltd (paragraph 9(1)). So overall it is considered to hold 13 percent. Icina Ltd sold 4 percent in the prior accounting period ended 31 December 2010, thus leaving a combined 9 percent holding, but this is effectively ignored – what matters is that Icina Ltd held more than 10 percent throughout any continuous period of twelve months beginning not more than two years prior to the disposal. So the exemption applies to the profit arising of £25,850.

Marking scheme

	Marks
Add back depreciation	½
Qualifying additions for general pool	
– resurfacing of car park	1
– air conditioning unit	1
– resurfacing ice rink	1
Calculating disposal proceeds	1
Capital allowances	
– AIA (and possible further discussion of whether available)	1*
– General pool	1
– Special rate pool	1
– Expensive car	1
Excess pension contributions	
– Spreading calculation	1
– Relevant excess contributions	1
– Disallowable amount	1
Exempt distribution	
– Large company	1
– Exempt class	1
– Control	1
– Deduct dividend	1
Substantial shareholdings exemption	
– Meaning of 'substantial shareholding'	1
– Aggregate with Itema Ltd	1
– Ignore previous sale	1
– Deduct profit on disposal of shares	1
Calculating taxable profits	½
Total	20

(*Additional marks available for discussion of availability and restriction of AIA for a single company and a group of companies.)

Answer 2

Transfer pricing: Difficulties in applying transfer pricing methods

I will consider the difficulties in applying three traditional transaction methods (CUP, resale price, cost plus) and one transactional profit method (transactional net margin).

Comparable uncontrolled price method or CUP method

The CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.

It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price.

Adjustments may be made to eliminate the material effect of any differences but it may be difficult to establish precisely what adjustments to make which would result in a reasonably accurate adjustment.

Resale price method

This method assumes that a product is purchased from an associated enterprise and then resold to an independent enterprise. The sale price of the product to the independent enterprise is reduced by an appropriate gross margin to provide the suitable price for the original transfer from the associated enterprise.

It may be difficult to apply the resale price method where the reseller adds substantially to the value of the product, for example, by further processing the goods or incorporating the goods into a more complicated product so that their identity is lost or transformed.

It may not be easy to establish the appropriate resale price margin – this would involve establishing the resale price margin of an independent enterprise in a comparable transaction and adjustments may have to be made if there are material differences in the ways the associated enterprises and the independent enterprise carry out their businesses.

Cost plus method

Under this method an appropriate cost plus mark up is added to the costs incurred by the supplier in a controlled transaction for property transferred or services provided to an associated purchaser.

It may be difficult to determine the costs incurred – an enterprise must cover its costs over a period of time to remain in business but those costs may not be the determinant of the appropriate profit in a specific case for any one year.

It may also be difficult to establish a comparable mark up to a comparable cost basis. Differences between the controlled and uncontrolled transactions that have an effect on the size of a mark up must be analysed to determine what adjustments need to be made.

Transactional net margin method

This method examines the net profit relative to an appropriate base (for example, costs, sales, assets) that a taxpayer realises from a controlled transaction. This net profit indicator should be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions; or that an independent enterprise would have earned in comparable transactions.

Information required to apply this method might not be available at the time of the controlled transactions – for example, the taxpayer might not have access to enough specific information on the profits attributable to comparable uncontrolled transactions.

There may be difficulties in determining an appropriate adjustment where it is not possible to work back to a transfer price. For example, where the taxpayer deals with different associated enterprises on the buying and selling sides of a controlled transaction, if this method indicates that the taxpayer's profit should be adjusted upwards, there may be some uncertainty about which of the associated enterprises' profits should be reduced.

Company residence

Relevance

A company that is UK resident is taxable on their worldwide income whereas a non-resident company will be chargeable to UK corporation tax only if they are carrying on a trade in the UK through a permanent establishment.

There are two residence tests: an incorporation test and a central management and control test. Where a company is incorporated in the UK, it is prima facie regarded as resident there for tax purposes. A company that is not incorporated in the UK is also considered to be UK resident if its place of central management and control is in the UK.

Where a company is considered to be UK resident but also resident in another State such that it has dual residency, there may be a double tax arrangement between the UK and that other State with a tie-breaker clause, typically the company is deemed to be resident only in the State in which its place of effective management is situated.

Central management and control

Case law has determined the meaning of ‘central management and control’ starting with *De Beers Consolidated Mines Ltd v Howe* where a company established and operated a business in South Africa but its important affairs were controlled from the UK, where the majority of the directors resided.

HM Revenue & Custom’s approach is set out in SP 1/90. The test looks at the highest level of control of the business of the company which may be distinguished from the place where the main operations of a business may be found.

The first step is to determine whether the directors in fact exercise central management and control. If so, the second step is to determine where that central management and control is exercised. Here the place of directors’ meetings will usually be of significance. But if the directors do not in reality exercise central management and control, the third step is to establish where and by whom it is exercised.

Place of effective management

The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the company’s business as a whole are in substance made. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

It is unlikely but possible for the place of effective management to differ from the place where central management and control is held. For example, a company could be run by executives based abroad but the final directing power rests with non-executive directors who meet in the UK.

The meaning of place of effective management and its distinction, if any, from the place of central management and control has so far not been considered by the UK courts.

Marking scheme

	Marks
2 marks available for each of 4 methods discussed from a possible 5 methods (CUP, resale price, cost plus, transactional net margin, transactional profit split)	8
Company residence – relevance	3
Central management and control	2*
Place of effective management	2
Total	15

(*Up to 2 additional marks available)

Answer 3

Draft e-mail response to Ms Giovan:

Dear Ms Giovan

Thank you for your e-mail dated X November 2012 detailing the overseas expansion plans of Potters Ltd. You have asked what 'permanent establishment' ('PE') means and whether or not Potters Ltd will have PEs in any of Switzerland, Norway and Egypt. You have also asked for advice on whether or not to make an exemption election and the tax consequences following such an election.

Definition of a permanent establishment

The definition of 'PE' under the UK tax legislation (Chapter 2 Part 24 CTA 2010) generally follows the definition under the OECD Model Convention. The three jurisdictions you mention follow the definition under the OECD Model Convention so there should be no dispute as to the definition of 'PE' with the tax authorities of those jurisdictions.

A company has a PE in a territory if (and only if),

(a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or

(b) an agent acting on behalf of the company has and habitually exercises their authority to do business on behalf of the company.

A 'fixed place of business' includes a place of management, a branch, an office, a factory and a workshop.

Where a company has a fixed place of business but the activities carried on there are only of a preparatory or auxiliary character, such as storage, display or delivery, the company will not be regarded as having a PE.

If there is an agent acting on behalf of the company but that agent is of independent status acting in the ordinary course of his or her business, the company is not regarded as having a PE.

Overall it is likely that where Potters Ltd has office space to conclude sale contracts and/or some manufacturing space, it will have a PE because there will be a fixed place of business and the activities carried on there will be more than that of a preparatory or auxiliary character.

Switzerland

Pitches (or even just one pitch) in a market place can constitute a 'place of business' and if there is a certain degree of permanence to the pitches, they may be considered 'fixed', in which case Potters Ltd will have a PE in Switzerland. It will depend on the regularity of the pitches (daily, weekly, monthly), location within a particular market, and whether there are ongoing contracts to rent a pitch rather than turn up and rent a pitch on an adhoc basis, etc.

Norway

If the customers' premises are not at the disposal of Potters Ltd, it would appear that Potters Ltd would not have a fixed place of business. If, however, the salesmen act on behalf of Potters Ltd and repeatedly have the authority to conclude sale contracts, it is likely that Potters Ltd will have a PE in Norway. This is unless the salesmen have independent status both legally and economically and act in the ordinary course of their business when acting on behalf of Potters Ltd.

Egypt

It is likely that Potters Ltd's presence at the delivery dock would be so limited that Potters Ltd could not be considered as having that place at its disposal. So it is unlikely that Potters Ltd will have a PE in Egypt.

Permanent establishment exemption election

A company can elect (under s18A CTA 2009) for the relevant profits and losses of a foreign PE to be left out of account when calculating the charge to UK corporation tax. The branch exemption will therefore be a good option where the foreign territory applies a lower rate of tax to profits than the UK.

The election is optional but once made it can only be withdrawn prior to the start of the first accounting period to which it relates. After that time it becomes irrevocable and applies to all the PEs of a company. So any losses arising from overseas branches will no longer be capable of relief against the profits of Potters Ltd. Given that in aggregate the PE

operations are likely to be loss making until year three, it might be advisable to delay making the election, although you may then need to consider the transitional rules.

Profits and losses are attributed to a PE in accordance with treaty principles using the actual treaty or the OECD model where there is no treaty. In general, profits that are attributable to a PE are the profits it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE. The exercise to attribute results to the PE can be tricky, particularly if the period for which the PE exists differs from the accounting period of the UK entity.

The exemption legislation does not require the subtraction of the UK measure of the foreign PE's profits from the UK tax computation of the company's worldwide profits. Instead, it identifies 'exemption adjustments' which are components of what would (in the absence of the exemption legislation) be the chargeable profits calculation that are (because of the exemption legislation) left out of account in calculating chargeable profits.

An exemption adjustment includes notional capital allowances that are automatically made. The notional capital allowances claim made is assumed to be that which produces the largest reduction in profits or increase in loss. There is no requirement for the company to actually make the claim.

The exemption legislation applies to capital gains and losses in a similar way to other profits and losses attributable to a PE. Assuming that the State in which the PE is situated is exercising taxing rights in accordance with the relevant treaty the gains and losses are 'left out of account' so to that extent, they are not actually chargeable gains or allowable losses of the company. The right to tax capital gains will normally be given to the State which is entitled to tax both the property and the income derived from it.

A profit attributable to a PE is referred to as a 'relevant profit amount' and a loss as a 'relevant loss amount'. Once an election is made, a company's relevant profits/losses amounts for each foreign territory are aggregated to form a 'foreign permanent establishment amount' which may be positive (if profits exceed losses) or negative (if losses exceed profits).

Please contact me if you have further queries.

Regards

A Tax Adviser

Marking scheme

	Marks
Definition of a permanent establishment	
– fixed place of business	1
– agent	1
– independent agent	1
Application to office space and manufacturing space	1
Application of definition to 3 scenarios	3 (1 mark per scenario)
Pros and cons of branch exemption	2*
Election irrevocable and applies to all PEs	1
How profits are attributable	1
Exemption adjustments	1
Capital allowances	1
Capital gains	1
Relevant profits and losses amount	1
Total	15

*Up to 2 additional marks available

Answer 4

Part (1)

Robotics Holdings plc ('RHplc') will prefer to sell the shares in Gadgets Ltd rather than assets because it will have no tax on capital gains in respect of the disposal provided that the terms of the Substantial Shareholding Exemption ('SSE') in Sch 7AC TCGA 1992 are met. The SSE applies in priority to the deemed no disposal rules in s136 TCGA 1992 (para 4 Sch 7AC TCGA 1992). In contrast, if Gadgets Ltd sells its trade and assets, it will have corporation tax in respect of credits arising on the disposal of goodwill. The SSE requires that the following conditions are satisfied:

The substantial shareholding condition: RHplc must hold at least 10% of the ordinary share capital of Gadgets Ltd, be entitled to at least 10% of the profits available for distribution to equity holders in Gadgets Ltd and at least 10% of the assets of Gadgets Ltd available for distribution to equity holders on its winding up (para 8(1) Sch 7AC TCGA 1992). RHplc must have held the substantial shareholding in Gadgets Ltd throughout a 12 month period beginning not more than two years before the date of the disposal for which SSE is sought (para 7 Sch 7AC TCGA 1992). This condition appears to be satisfied because Gadgets Ltd is a subsidiary of RHplc and appears to have been such since January 2003.

The investing company condition: RHplc must have been a trading company or a member of a qualifying group throughout the period beginning with the start of the latest 12 month period required for the substantial shareholding condition and ending with the date of disposal for which SSE is sought and must be a trading company or member of a qualifying group immediately after the disposal (para 18(1) Sch 7AC TCGA 1992). A qualifying group includes a trading group. A trading group means a group one or more of whose members carry on trading activities and the activities of whose members taken together do not include to a substantial extent activities other than trading activities. It appears that RHplc is a member of a qualifying group since it has three trading subsidiaries before disposal of shares in Gadgets Ltd and has two trading subsidiaries immediately after the disposal.

The investee company condition: Gadgets Ltd must have been a qualifying company throughout the period beginning with the start of the latest 12 month period required for the substantial shareholding condition and ending with the date of disposal for which SSE is sought and must be a qualifying company immediately after the disposal (para 19(1) Sch 7AC TCGA 1992). 'Qualifying company' including a trading company and Gadgets Ltd satisfies this condition because it is a trading company.

Therefore RHplc appears to qualify for the SSE in respect of a disposal of the shares in Gadgets Ltd and would prefer to sell shares (rather than Gadgets Ltd sell its trade and assets) as there will be no tax liability.

A purchaser would prefer to purchase the assets of Gadgets Ltd because this means that it will obtain full relief in respect of the cost of goodwill forming part of the Gadgets Ltd's trade. The intangible fixed assets regime applies to goodwill as it applies to an intangible fixed asset. Goodwill has the meaning it has for accounting purposes and includes internally generated goodwill (s715 CTA 2009). A company can elect to write down the cost of an intangible fixed asset for tax purposes at a fixed rate (s730 CTA 2009).

Part (2)

Commentary on the Tax Consequences of the Proposed Reorganisation

(1) Tax effects of Steps (1) and (2)

The effect of Gadgets Ltd being put into liquidation in Step (1) is that the accounting period of the company ends immediately before the commencement of liquidation and a new accounting period begins with the commencement of liquidation (s12 CTA 2009).

Extra statutory concession D33 deals with indemnity payments. Gadgets Ltd acquires the right to an indemnity for a nil consideration and nil capital gains base cost. Any payment of the indemnity by RHplc can give rise to a capital gain.

(2) Tax effects of Step (3)

(1) Tax on Capital Gains

The proposal does not give rise to any tax on capital gains for RHplc or its group for the following reasons:

Step (3) would (except for the application of s136 TCGA 1992) involve a disposal by RHplc of its shares in Gadgets Ltd by the operation of the capital distributions rule (s122 TCGA) when the trade and assets of Gadgets Ltd are transferred to JV Ltd and JV Ltd issues shares to RHplc. This rule treats the receipt of a capital distribution in a winding up as a part-disposal of the shares of the company being wound up.

There is deemed to be no disposal at Step (3) and the shares in JV Ltd are deemed to be the same asset as the shares in Gadgets Ltd acquired at the same price and the same time where the conditions in s136 TCGA 1992 are satisfied. S136 requires that there must be:

(a) an arrangement between Gadgets Ltd and the person/s holding shares in it;

(b) the arrangement must be entered into for the purpose of a scheme of reconstruction within Sch 5AA TCGA 1992; and

(c) under the arrangement another person issues shares or debentures to the shareholders in Gadgets Ltd in proportion to their holdings in Gadgets Ltd and the shares in Gadgets Ltd are retained or cancelled.

Sch 5AA TCGA 1992 requires that the first and second and either the third or the fourth conditions are satisfied. The first condition requires the issue of the ordinary share capital of a successor company (ie JV Ltd) to holders of ordinary share capital in the original company (ie Gadgets Ltd) which does not consist of the issue of ordinary share capital of the JV Ltd to anyone else. The second condition requires that the entitlement under the scheme or reconstruction of any person holding ordinary share capital in the original company to acquire ordinary share capital of the successor company to be the same as that of any other person holding ordinary share capital in the original company. The third condition requires that, when there is one original company, the business or substantially the whole of the business carried on by the original company is carried on by a successor company which is not the original company. Therefore the first, second and third conditions are all satisfied.

The fact that a contingent liability is left behind in Gadgets Ltd should not normally prevent the satisfaction of the third condition. It will be necessary that the scheme of reconstruction must be effected for bona fide commercial purposes with no main purpose of avoiding capital gains tax or corporation tax (s137 TCGA 1992) and a clearance should be sought from HM Revenue & Customs under s138 TCGA 1992.

The effect of s136 is that RHplc is treated as making no disposal of its shares in Gadgets Ltd (assuming that RHplc receives nothing in respect of its shares in Gadgets Ltd apart from the shares in JV Ltd) and its new shares in JV Ltd are treated as being the same asset as the old shares in Gadgets Ltd acquired at the same price and at the same time.

ss731 to 751 CTA 2010 (whereby, in certain circumstances, capital gains on the disposal of shares in a company can be converted into income) contain widely-worded anti-avoidance legislation and it would be advisable to apply for clearance from HM Revenue & Customs that they will not apply these provisions at the same time as making the clearance application under s138 TCGA 1992.

(2) Intangible Fixed Assets

At Step (3) Gadgets Ltd transfers its intangible assets in the form of goodwill to the JV Ltd at market value. This should be a tax-neutral transfer if s818 CTA 2009 applies.

The meaning of tax-neutral transfer is that the transfer is treated as not involving the realisation of an asset by Gadgets Ltd nor the acquisition of an asset by JV Ltd and JV Ltd is treated as having held the goodwill at all times when held by Gadgets Ltd and having done all things in relation to the goodwill as were done by Gadgets Ltd (s776 CTA 2009). S818 requires that there should be a scheme of reconstruction (under Sch 5AA TCGA 1992) involving the transfer of the whole or part of the business of Gadgets Ltd to JV Ltd. The intangible fixed assets must be chargeable intangible assets of Gadgets Ltd before the transfer and of JV Ltd after the transfer (the goodwill is post 31 March 2002 goodwill). The

genuine commercial transaction requirement in s831(1) CTA 2009 must be met and a clearance should be sought from HM Revenue & Customs under s831(2). The effect of the application of s818 is that the transfer of the intangible fixed assets from Gadgets Ltd to JV Ltd is a tax neutral transfer.

(3) Stock

If there is a sale, Gadgets Ltd and JV Ltd are not connected so that the value of the stock taken into account on the sale of the Gadgets Ltd trade to JV Ltd at Step (3) will be determined by the amount realised on the sale under s165 CTA 2009. S165 applies because JV Ltd carries on a trade in the UK and is entitled to deduct the cost of stock as an expense in calculating its profits. S165(3) contains provisions for a joint and reasonable apportionment. If there is no sale, the value of the stock taken into account should be market value on the basis of the principle in Sharkey v Wernher.

(3) The effects of Step (4)

There are no particular tax effects for Step (4). However, if RHplc sells its shareholding in JV Ltd within a year of the transaction, the SSE may be available in respect of this disposal. Para 14 Sch 7AC TCGA 1992 applies to deem the substantial shareholding condition in para 7 Sch 7AC to be met by the holding of shares in JV Ltd and Gadgets Ltd.

The investing company condition in para 18(1) will be met because RHplc will be a member of qualifying group within the period up to the date of the disposal of the JV Ltd shares as Para 23 Sch 7AC TCGA 1992 deems RHplc to be carrying on the appropriate portion of the trading activities of the joint venture company. Immediately after a disposal, RHplc will be a member of a trading group as it will still have two trading subsidiaries.

The investee company condition in para 19 Sch 7AC will be met by virtue of para 25 Sch 7AC so that JV Ltd can be treated as a qualifying company within the one year period up to the date of disposal of the JV Ltd shares and immediately thereafter both by reference to JV Ltd and by reference to the activities of Gadgets Ltd.

Marking scheme

	Marks
Sale of shares in Gadgets Ltd/Sale of Business in Gadgets Ltd	
Refer to reasons why RHplc wishes to sell shares	3
Refer to reasons why purchaser wishes to purchase business	2
Tax effects of proposed reorganisation	
Tax effects of Steps (1) and (2)	2
Tax effects of Step (3)	
Tax on capital gains – shareholding in Gadgets Ltd	
Refer to s136 TCGA 1992	3
The non-application of paragraph 4(1)(b) Schedule 7AC TCGA 1992	2
Refer to ss731 to 751 CTA 2010	1
Intangible fixed assets	
Refer to s818 CTA 2009 and describe the applicable conditions	3
Stock	
Refer to s165 CTA 2009 and describe the conditions	2
Describe why SSE applies if there is a sale of shares in JV Ltd	2
Total	20

Answer 5

To: Tax Partner

From: Tax Manager

Date: November 2012

Subject: Recapitalisation of Frenetics plc

Utilisation of non-trading deficits and trading debits

The basic rule is that non-trading deficits of an accounting period can be carried forward against non-trading profits of the relevant company in later accounting periods (s457 CTA 2009) so far as not surrendered by way of group relief or not subject to claim under s459 CTA 2009 for set off against its profits in the deficit period or an earlier period. Any claim under s459 CTA 2009 must be made within two years after the deficit period and can either be against profits of whatever description in the deficit period (s459(1)(a) CTA 2009) or can then be carried back to be set against profits of earlier accounting periods.

Trading debits can be deducted in the same way as expenses of a trade (s297(3) CTA 2009). Trading losses can be set against the company's total profits of the accounting period for which the losses are made (s37(3) CTA 2010) or against total profits that fall within previous accounting periods falling within the period of 12 months ending immediately before the loss making period as claimed in each case (s37(3)(b) CTA 2010). Insofar as the trading loss is not relieved under s37 CTA 2010, the losses can be carried forward against trading profits of succeeding accounting periods (s45 CTA 2010).

The tax effects of Step (1)

No credit arises in KL by virtue of the write-off because of s358 CTA 2009 since an amortised cost basis of accounting would be used in respect of KL's debtor relationship and the relationship would be a connected companies relationship. It is assumed that there is no deemed release or release of relevant rights under s358(2) CTA 2009. An amortised cost basis of accounting would be applicable because the loan relationship between SL and KL is a connected companies relationship (s349 CTA 2009). SL would obtain no release debit in respect of the write off of its creditor relationship by virtue of s354 CTA 2009.

Tax effects of Step (2)

SL sells the shares in KL to Fplc at market value. SL is deemed to make no disposal of its shares in KL provided that s135 TCGA 1992 applies. The conditions are satisfied because Fplc issues shares to SL in exchange for the shares in KL and Fplc holds in consequence of the exchange more than 25% of the ordinary share capital of KL. The share exchange must take place for bona fide commercial reasons with no 'main reason' capital gains tax or corporation tax avoidance within s137 TCGA 1992. A clearance can be sought under s138 TCGA 1992. The effect of the application of s135 TCGA 1992 is that SL is treated as making no disposal for capital gains purposes and acquires the new shares in Fplc as the same asset acquired at the same time as the shares in KL. The transfer of the shares in KL by SL to Fplc is not a no-gain no-loss transfer within s171 TCGA 1992 because of s171(3) TCGA 1992. Fplc therefore acquires the shares in KL at market value for capital gains purposes by virtue of s17(1) TCGA 1992 and the fact that SL receives market value consideration.

The proposal ensures that interest deductions occur in Fplc where they can be carried forward against trading profits. SL will group relieve its non-trading debits to set against KL's non-trading credits or Fplc's trade profits (if any in year). If KL had merely recapitalised its loan to Fplc there would have been the danger of non-trading debits being isolated in SLif Fplc did not have sufficient trading profits in a relevant account period.

Tax effects of Step (3)

S126 TCGA 1992 provides that a reorganisation of share capital includes a reduction in share capital. Therefore the reduction in share capital of Fplc is taken as not involving a disposal and SL's shareholding in Fplc is treated as being the same asset as its shareholding before the reduction acquired at the same time and at the same price.

Tax effects of Step (4)

The dividends paid by KL to Fplc and by Fplc to SL will be exempt in the hands of each of Fplc and SL under s931D and s931E CTA 2009.

Transfer pricing – interest rates

S152 TIOPA 2010 requires that all factors must be taken into account in determining the arms length interest rates on the loans between the companies, including:

(1) the question whether the loan would have been made at all in the absence of a special relationship;

(2) the amount of the loan in the absence of a special relationship; and

(3) the rate of interest and other terms which would have been agreed in the absence of a special relationship.

It will be essential to ensure that all these conditions are observed in relation to the loans made by H GmbH to SL and the onward loans.

Deduction of UK tax from interest

Fplc can pay all interest to KL and KL can pay any interest to SL without the deduction of UK tax under s933 ITA 2007. SL can pay interest gross to H GmbH provided, for example, that H GmbH has made a claim under the Article 11 Germany/UK Double Tax Treaty and SL has received authority from HM Revenue & Customs to pay the interest gross as a result of that claim.

Marking scheme

	Marks
Comparison of the utilisation of non-trading deficits and trading debits	3*
Tax effects of Step (1)	
Tax effects of the write off of the loan to KL	3
Tax effects of Step (2)	
Capital gains effects	2
Reorganisation of interest deductions in group	2
Tax effects of Step (3)	
Tax effects of reduction of share capital	1
Tax effects of Step (4)	
Tax treatment of dividend	1
Transfer pricing and Deduction of UK tax on interest	3
Total	15

Answer 6

(1) Capital Gains and stamp duty land tax ('SDLT') effects of acceptance of offer

S179 TCGA 1992

S179 TCGA 1992 applies on the disposal by Oakington Education Ltd of the shares in Area B Ltd. The conditions in s179(1) and (3) will be satisfied in that:

(a) Area B Ltd acquires assets (ie the Oakington Education Ltd trade and assets carried on in Area B) from Oakington Education Ltd at a time when both Oakington Education Ltd and Area B Ltd are members of the same group; and

(b) Both Oakington Education Ltd and Area B Ltd are resident in the UK therefore satisfying the conditions in Section 179(1A); and

(c) Area B Ltd ceases to be a member of the Oakington Education Ltd group within six years from the time of the acquisition holding the relevant assets other than as trading stock.

By virtue of S179 (3A) TCGA 1992 the capital gain realised by Area B Ltd on the disposal of the shares in Area B Ltd is increased by the s179 chargeable gains. It is not exempt in the hands of Oakington Education Ltd by virtue of the substantial shareholding exemption ('SSE') because the substantial shareholding exemption has not been satisfied since there is no twelve month period. Para 15A Sch 7AC TCGA 1992 does not apply to extend the twelve month period because there was no capital gains group before the creation of Area B Ltd. Area B Ltd and its new owner, the third party purchaser, receive a tax-free step up in capital gains base cost for the chargeable asset in Area B Ltd.

The above can be shown in computational form as follows:

S179 Chargeable Gain	£
Market value of Area B Ltd's only chargeable asset at time of acquisition	10,000,000
Less base cost	Nil
Chargeable gains	10,000,000

Chargeable gains for Oakington Education Ltd	£
Disposal proceeds of shares in Area B Ltd	8,000,000
Less base cost	6,000,000
Chargeable gains	2,000,000
Add s179 chargeable gains	10,000,000
Total chargeable gains on disposal of shares in Area B Ltd	12,000,000

Stamp Duty Land Tax

Oakington Education Ltd and Area B Ltd form a group for SDLT purposes within para 1 Sch 7 FA 2003. Therefore there should be an exemption from SDLT on the transactions in land provided that none of the restrictions in para 2 Sch 7 FA 2003 apply. This means that:

(a) there must be no arrangements by virtue of which at some later time a person could obtain control of Area B Ltd but not Oakington Education Ltd (except for an acquisition of shares to which s 75 FA 1986 applies);

(b) there must be no arrangements whereby the consideration for the transaction in land is to be provided by a non-group company or whereby Oakington Education Ltd and Area B Ltd are to cease to be members of the same group by the latter company ceasing to be 75% subsidiary of the first company or a third company;

(c) the transactions must be effected for bona fide commercial purposes with no main purpose of the avoidance of liability to tax which means stamp duty land tax, stamp duty, income tax, corporation tax or capital gains tax.

It is likely that group relief will apply on the transfer of land interests by Oakington Education Ltd to Area B Ltd. However the group relief will be withdrawn by virtue of para 3 Sch 7 FA 2003 because Area B Ltd would cease to be a member of the same group as Oakington Education Ltd within three years of the effective date of the

transactions. Hence Area B will be liable to SDLT of 4% × £10m, the market value of the building at the date of the transfer.

(2) Sale of the Shares in Area B Ltd in four years time

In the case of the alternative facts where Oakington Education Ltd will have held the shares in Area B Ltd for nearly five years, the tax on capital gains effects for Oakington Education Ltd is the same as in paragraph 1 except that in this case the SSE is available on the sale. This is because Oakington Education Ltd does satisfy the substantial shareholding condition having held the shares in Area B Ltd for at least the requisite 12 month period. The chargeable gains computation for Oakington Education Ltd is as follows:

	£
Proceeds of the disposal of the shares in Area B Ltd	8,000,000
Less capital gains base cost	6,000,000
Capital gain	2,000,000
Add s179 Chargeable gain	10,000,000
Total capital gain – exempt by virtue of SSE	12,000,000

SDLT

The group exemption should apply to the land transaction between Oakington Education Ltd and Area B Ltd when all the assets and liabilities of Area B are transferred by Oakington Education Ltd to Area B Ltd. However the exemption will not be withdrawn by virtue of para 3 Sch 7 FA 2003 if Area B Ltd does not cease to be a member of the same group as Oakington Education Ltd within three years of the effective date of the transactions and there are no arrangements for it to do so before that date.

Marking scheme

	Marks
Capital gains and SDLT consequences of accepting the unsolicited offer	
Description of s179 TCGA 1992	3
Description of operations of s179(3A) onwards TCGA 1992 with reference to uplift in capital gains base cost to market value of chargeable asset of Area B Ltd	2
Description of operation of SDLT group provisions	3
Computation of chargeable gains under paragraph 1	3
Capital gains and SDLT consequences of sale of shares in Area B Ltd after three and a half years of ownership	
Description of s179 TCGA 1992 and SSE	2
Description of operations of SDLT group provisions	1
Computation of chargeable gains under paragraph 2	1
Total	15