The Chartered Tax Adviser Examination

November 2011

Advanced Corporation Tax

Advisory Paper

Suggested answers without marks

Answer 1

Target 1

Group relief (for trading losses and certain other types of loss, including non-trading loan relationship deficits) is available where the surrendering and claimant companies are members of the same group. Two companies will be members of the same group if one company is a 75% subsidiary of the other or both are 75% subsidiaries of a third company. A company (A) is a 75% subsidiary of another company (B) if more than 75% of A's ordinary share capital is owned directly or indirectly by B. Ordinary share capital in relation to a company means all the company's issued share capital (however described) other than share capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits.

For group relief purposes, further conditions must also be satisfied however. The parent company must be entitled to not less than 75% of any profits available for distribution to equity holders and not less than 75% of assets that would be available for distribution to equity holders on a winding up. The profits available for distribution to equity holders are the total profits for the accounting period, or £100, where there are no such profits. The assets available for distribution in a winding up comprise excess assets over liabilities as shown in the company's balance sheet at the end of the accounting period, or where this cannot be ascertained, or there is no excess, £100.

An equity holder is any person holding ordinary share capital or a loan creditor in relation to a loan that is not a normal commercial loan.

Post-acquisition, group relief will be available between the acquired companies and the other members of the Holdings Plc group for post-acquisition losses and profits only. For the accounting period in which the acquisitions take place, the post-acquisition proportion of losses and profits will be determined initially on a time basis but if that produces a result that is unjust or unreasonable another basis can be used so far as is necessary to produce a result that is just and reasonable.

Prima facie Bach Ltd, Chopin Ltd and Dvorak Ltd are all 75% subsidiaries of Albinoni Ltd and so, subject to the equity interest tests, group relief may be available between the companies themselves, and post acquisition, between the acquired companies and other UK members of the Holdings Plc group.

The following issues arise with the equity interest tests.

BACH LTD

Options

When option arrangements exist, for the purposes of calculating the equity holders' entitlements the options must be treated as having been exercised. Therefore once the employee share options are granted, Albinoni Ltd will no longer be entitled to 75% or more of the profits available for distribution to equity holders and Bach Ltd and Chopin Ltd will cease to be members of the same group relief group as Albinoni Ltd. Consequently post acquisition, they will also cease to be members of the same group relief group as other members of the Holdings plc group. Although some approved employee share option schemes can be ignored for these purposes, this does not apply to unapproved employee share option schemes.

Loan

An equity holder is any person holding ordinary share capital or a loan creditor in relation to a loan that is not a normal commercial loan. To be a normal commercial loan the loan must not entitle the loan creditor to any amount by way of interest that:

- depends to any extent on the results of the company's business; or
- depends to any extent on the value of any of the company's assets or
- exceeds a reasonable commercial return on the new consideration lent.

The loan creditor must also be entitled, on repayment, to an amount which either does not exceed the new consideration lent or is comparable with the amount generally repayable under the terms of issue of securities listed on a recognised stock exchange.

However, a loan will not be excluded from being a normal commercial loan as a result of the loan creditor being entitled to an amount by way of interest that depends to any extent on the value of the company's assets provided the terms of the loan provide for the rate of interest to be reduced in the event of the value of the company's assets increasing; or for the rate of interest to be increased in the event of the company's assets diminishing.

In the case of the loan to Bach Ltd this should be regarded as a normal commercial loan (so long as the rate of return does not exceed what would be regarded as a reasonable commercial return) as the rate of interest on the loan only increases if the value of the company's assets reduces. Bach Ltd will therefore be in the same group relief group as Albinoni Ltd (until the grant of the options) and accordingly will become a member of the same group relief group as other members of the Holdings plc group after acquisition.

CHOPIN LTD

To be a normal commercial loan the loan must not carry any right to conversion into shares or securities of any other description (except into restricted preference shares or shares or securities in the company's quoted parent company). The Loan to Chopin Ltd is therefore not a normal commercial loan and so whether Chopin Ltd is in the same group relief group with Albinoni Ltd, Bach Ltd or Dvorak Ltd (and post acquisition with other members of the Holdings Plc group) will depend on whether the bank will be entitled to more than 25% of the profits available for distribution to equity holders or entitled to more than 25% of the assets that would be available for distribution on a winding up.

In particular, if Chopin Ltd is loss making in any accounting period (in which case its profits for the purposes of the equity interest tests are assumed to be £100) or its profits (before deduction of the bank loan interest) are less than £20k, it will not be a member of the same group relief group as Albinoni Ltd, Bach Ltd or Dvorak Ltd since the payment of the £5k interest on the bank loan would in those circumstances exceed 25% of the profits available for distribution to the equity holders.

DVORAK LTD

An equity holder is any person holding ordinary share capital or a loan creditor in relation to a loan that is not a normal commercial loan. Ordinary shares for this purpose are all shares other than restricted preference shares. To qualify as restricted preference shares, the share must, in particular, not carry a right to a dividend other than a fixed amount or at a fixed percentage rate (or a fluctuating rate where the rate fluctuates in accordance with the RPI or other similar general index of prices issued by the government) of the nominal value of the shares and the company must not be entitled to reduce the amount of, or not pay, the dividends (except in limited circumstances).

In addition to these conditions on the restricted right to dividends, shares have to meet the following conditions in order to qualify as restricted preference shares:

(a) The shares were issued for a consideration which includes new consideration (so, for example, shares issued on a bonus issue cannot be restricted preference shares);

(b) The shares do not carry the right to conversion into other shares or securities (except into other restricted preference shares or shares or securities of the company's quoted parent company);

(c) The shares do not carry any right to the acquisition of other shares and securities;

(d) On repayment, the shares do not carry the right to an amount exceeding the new consideration given for the shares (except so far as those rights are reasonably comparable with those generally carried by listed fixed dividend shares), and

(e) The rate of the dividends on the shares is no more than a reasonable commercial return on the new consideration given for the shares.

Since the preference shares in Dvorak Ltd are non-cumulative, they will probably not be restricted preference shares (the Articles would need to be examined to determine the precise rights) and so are regarded as ordinary shares (and therefore as equity) for the purposes of the equity interest tests. Whether Dvorak Ltd is in the same group relief group as Albinoni Ltd, Bach Ltd and Chopin Ltd (and post acquisition, in the same group relief group as other members of the Holdings Plc group) for an accounting period will therefore depend on whether the profits of Dvorak Ltd exceed £80k and whether the preference shares have preferential rights to repayment on a winding up.

Other factors which might, were they to be present, more generally affect the group relief position are:

- Arrangements for any of the four companies in the target group to cease to members of the same group, or for a person (or persons together) to obtain control of one or more of the companies (and not the others) or for the transfer of the trade of one or more of the companies to a non-group company.
- Any other option arrangements in connection with the shares in any of the companies.
- Any shares issued by any of the four companies in the target group having limited rights or temporary rights.

Answer 2

USE OF LOSSES

Brown Ltd's accounting periods (APs) and its losses, which are time-apportionments of the loss accruing in the whole period from 1 January 2011 to 30 September 2011, are as follows:-

1 January 2011 to 31 March 2011

(date of commencement of administration) (£600,000)

1 April 2011 to 31 August 2011

(date of commencement of liquidation) (£1,000,000)

1 September 2011 to 31 August 2012

(12 months) (£200,000)

1 September 2012 to 31 September 2012 (completion of winding up)

An AP ends when the company goes into administration, and also when it goes into liquidation. Subsequent APs run for 12 months or until such time as the winding-up is completed if earlier. An AP does not end on cessation of trade during winding-up.

Loss relief is available, on a claim, for trading losses incurred in an AP of Brown Ltd prior to cessation of trade as follows:-

(1) Group relief against profits of corresponding APs up to the date of going into liquidation. Losses arising after the company has gone into liquidation cannot be group relieved. For non-coterminous APs, the relief is limited to the lower of the profits of the claimant and the losses of the surrendering company which correspond to the overlapping period. Group relief is given in priority to any loss carried back (as below).

    [Bonus mark for candidates discussing whether group relief will be available whilst in administration as shareholders may be unable to secure that the company's affairs are conducted in accordance with their wishes]

(2) Carry back losses of an AP against profits arising in an AP falling within the preceding 12 months, so long as the same trade was carried on in that period. The profits eligible for relief are proportionately reduced where the relieved AP in question falls partly outside the 12 month period.

(3) Carry back of

    (i) the whole of the losses incurred in APs beginning in the 12 months preceding cessation of trade on 30 September 2011 and

    (ii) losses incurred in APs ending but not beginning in that 12 month period, proportionate to the part of the AP falling within those 12 months

    against profits of APs falling wholly or partly within the period of 3 years preceding the AP of loss, providing the company was carrying on the same trade in the periods for which profits are relieved.

    The profits eligible for relief are proportionately reduced where the relieved AP in question falls partly outside the 3 year period.

    Relief by carry back is given for earlier losses before later losses and is given against most recent profits before earlier profits, and relief can be given only once by group relief or carry back of the same loss.

Therefore

(a) Brown Ltd can surrender, as group relief, £90,000 to Red Ltd in AP ended 31 December 2010 reducing available loss to £240,000 (£330k−£90k).

    It can also surrender £15k of losses arising in AP ended 31 March 2011 , being 3/12 (corresponding to the overlapping period) of £60k of losses and £25k of losses arising in AP ended 31 August 2011, being 5/12 of £60k losses), to Red Ltd in respect of Red Ltd's AP ended 31 December 2011.

    Given that the liquidator has to maximise the value of Brown Ltd's assets, Brown Ltd would expect to be paid for group relief surrenders at an amount up to the tax value of the losses to the claimants.

(b) Brown Ltd's remaining loss of the AP to 31 December 2010, £240k, can be carried back against its own profits of AP ended 31 December 2009

(c) Brown Ltd has four APs/part APs where losses are potentially available for 3 year carry back:

    (i) 3/12 of AP ended 31 December 2010, from 1 October 2010 to 31 December 2010, 3/12 × nil (after 1 year carry back above) = nil

(ii) all of the AP 1 January 2011 to 31 March 2011 (after group relief as above) = £585,000

(iii) all of the AP 1 April to 31 August 2011 (after group relief as above) = £975,000

(iv) all of the AP ended 31 August 2012 = (£200,000)

The £585k loss from the three months ended 31 March 2011 may therefore be carried back against profits of the APs ended 31 December 2009 and then 2008 (ie against profits arising since 1 January 2008).

The £975k loss from the five months ended 31 August 2011 can be carried back against profits of the APs ended 31 December 2009 and a proportion (9/12) of year ended 31 December 2008 (ie against profits arising since 1 April 2008).

The £200k loss from the year ended 31 August 2012 can be carried back against profits of the APs ended 31 December 2009 and a proportion (4/12) of year ended 31 December 2008 (ie against profits arising since 1 September 2008).

The losses will therefore be offset as follows:

	Y/e 31 December 2008	*Y/e 31 December 2009*	*Total loss relieved by carry back*	*Group relief as above*	*Total loss relieved*	*Loss unrelieved*
Profits before loss relief	960,000	900,000				
Losses AP to 31/12/10		(240,000)	(240,000)	(90,000)	(330,000)	Nil
Losses AP to 31/3/11		(585,000)	(585,000)	(15,000)	(600,000)	Nil
Losses AP to 31/8/11	(720,000)	(75,000)	(795,000)	(25,000)	(820,000)	(180,000)
Losses AP to 31/8/12	(80,000)		(80,000)		(80,000)	(120,000)
Profit after loss relief	160,000	Nil				

The £180,000 residual, unrelieved loss can be carried forward to be relieved against the post- cessation receipt (PCR) , by virtue of CTA 2009 Section 196(2). Alternatively, the PCR can be elected back under Section 198. In addition the residual loss of £120,000 arising in AP ended 31/8/12 can be relieved against the PCR under normal set –off against general income rules.

TRANSFER OF ASSETS TO YELLOW LTD

Since entering liquidation Brown Ltd no longer has a beneficial interest in its assets. However, Green Ltd has a beneficial ownership of the shares in Yellow Ltd immediately after the transfer, and it also had beneficial ownership of the trade through its shareholding in Brown Ltd until Brown Ltd went into liquidation less than a year before the transfer. The transfer of the trade to Yellow Ltd is therefore afforded the reliefs available for transfers between group companies (ie successions to trade under common ownership per s.938 CTA 2010). Accordingly, capital allowances transfer at TWDV to Yellow Ltd. Any accumulated trading losses will pass to Yellow Ltd. However, they will be restricted to the extent that liabilities are not transferred to Yellow Ltd.

The transfer from Red Ltd of the property is no/gains no loss transfer for gains purposes. However, when Yellow Ltd is sold, there will be a capital gains exit charge in respect of the property computed by reference to market value at the date of transfer to Yellow Ltd. The gain can be elected back to Brown Ltd, or other group member, to be relieved against any otherwise unrelieved current period trading losses, or any available capital gains losses. Similar charges will apply to any other chargeable assets transferred from Brown Ltd to Yellow eg goodwill.

DISTRIBUTIONS

Both of the distributions are made in the course of the winding up and represent consideration for the disposal of shares in Brown Ltd by Green Ltd. Each distribution received represents a part-disposal of the shares in Brown Ltd.

Brown Ltd was also a trading company at a point in the two years preceding the disposals and so potentially qualifies for the Substantial Shareholder Exemption (SSE). However, Green Ltd, the holding company does not satisfy the condition of being a trading company or a member of a trading group after the disposal, nor is its inability to satisfy that condition by reason of its being wound up. Therefore the SSE will not be available to it.

Accordingly, both distributions give rise to capital gains disposals, in the APs of Green Ltd for the years ended 31 December 2011 and 31 December 2012 respectively.

Answer 3

To Group Finance Director

Consolidated Pharmaceuticals plc

You asked me to consider the tax history of group companies over the past six years. I enclose factual notes (as shown on exam paper) of five issues that have come to light in the course of my review and I set out below the consequences and proposed course of action to resolve these issues**.**

(1) Y/e 31 March 2007 - the company can claim relief for overpaid tax for any accounting period ending not more than four years ago. As this accounting period ended more than four years ago, no relief can be claimed**.**

Y/e 31 March 2008 - as the computation remains open the relief can be claimed by submitting an amended computation. Insofar as a tax refund arises, this will carry interest from the material date being the later of the date the tax was paid and the due date (whether by instalments or nine months after accounting period end). The interest rate on instalments, calculated up to the nine month due date, is at a special (lower) rate than the standard rate. The interest receivable is taxable.

(2) Y/e 31 March 2009 - relief for overpaid tax for this AP can only be made by way of claim. This is because the enquiry window is closed and therefore an amended return cannot be submitted. However a claim for relief from overpaid tax cannot be made for something which should have been claimed but was overlooked. R&D relief is given in a claim so a claim cannot be made for this AP.

Y/e 31 March 2010 On the other hand, the enquiry window for the 2010 AP is still open so a deduction for R&D should be claimed by submitting an amended return. The interest consequences are as (1) above**.**

(3) The company, by reason of its central management and control being in the UK, is resident in the UK for tax purposes and as such is liable to tax on its worldwide income since 1 April 2009**.**

It has failed to notify chargeability within 12 months of the end of its accounting period ended 31 March 2010**.** HMRC will be able to make a discovery assessment to collect the tax due and the company will be liable to interest (tax deductible) from when the tax was due until the date of payment. The company is also liable to a penalty of between 100% and 30% of the tax payable depending on whether the failure was deliberate and concealed, or deliberate but not concealed, or careless. The penalty can be mitigated depending on whether the disclosure is voluntary, or voluntary and unprompted.

(4) (a) Y/e 31 March 2006 - it is likely that HMRC will contend that this error arises from carelessness and so the normal four year time limit for discovery assessments is extended to six years**.** Interest is due from the date tax should have been paid. HMRC is likely to seek a tax-geared penalty - as in (3) above.

(b) Y/e 31 March 2008 - the additional tax will be collected by HMRC requiring an amended return to be submitted within 30 days of the notice of closure of enquiry**.** Interest is due from the normal due date.

Y/e 31 March 2007 - this year is out of time for a normal discovery assessment, which is up to four years after the end of the accounting period, so HMRC will be unable to collect the additional tax on the adjustment, unless it can contend successfully that the underpayment of tax is due to carelessness in which case the period for making a discovery assessment is extended to six years.

(c) y/e 31 March 2009 - the additional tax will be collected by way of a discovery assessment and interest and penalties will be sought on the lines indicated at (4)(a) above.

(5) The company is liable to a £100 penalty for failing to disclose the scheme reference number on its return, if this is the first offence. Second and subsequent offences carry penalties of £500 and £1000 respectively

Recommendations to resolve

There are three situations referred to above, paragraph 3, paragraph 4(a) and paragraph 4(c) where additional tax is due which arises out of circumstances where HMRC might contend that penalties are due. The level of penalties can be mitigated by early and voluntary disclosure. Before making disclosures, however, consideration should be given to how HMRC is likely to respond to the disclosures.

In particular, the deliberate omission of the entertaining disallowance at paragraph 4(c)

(a) will attract a higher level of penalty by reason of its being, at least at first sight, deliberate and concealed.

(b) is likely to lead to HMRC questioning whether there are other similar deliberate omissions and understatements elsewhere in the group's tax returns**.**

The group's position might best be protected by advising HMRC of the omission so far identified and agreeing with it the scope of an internal review with a view to identifying and voluntarily disclosing any other such omissions/understatements. This approach will also enable us to claim maximum mitigation of penalties for voluntary disclosure.

Consideration should also be given to offering voluntary restitution (ie paying voluntarily tax which is not strictly due in respect of the out of time liability at paragraph 4(b) above for AP ended y/e 31 March 2007 for Drug Manufacturing (UK) Ltd, especially if that amount of tax turns out to be relatively modest compared to the penalty, as this gesture might persuade HMRC further to reduce penalty loading**.**

Answer 4

To Finance Director

EuroAmerican Holdings Ltd

Introduction

Under UK transfer pricing legislation, an adjustment is required to be made to the profits of an "advantaged person" where provision has been made by means of a transaction or series of transactions between persons, "the affected persons", one of whom controls the other through participation in the management, control or capital of the other, or some other person so controls both of them, whereby that provision is different from what it would have been if it had been an arms' length provision.

The legislation requires account to be taken of OECD transfer pricing guidelines contained within the OECD Model Tax Convention and the published OECD Transfer Pricing Guidelines for Multinational Enterprises.

The OECD Model Tax Convention (double tax treaty) requires, at Article 9, that profits on transactions between associated enterprises are calculated as if they were independent parties**,** the "arms' length " principle.

Article 11 deals with the treatment of interest and specifically addresses the treatment of amounts of interest which are excessive as a result of a special relationship between the parties. Such amounts are not to be treated as interest under the double tax treaty but are to be taxed separately under the laws of the Contracting States.

Where the effect of an adjustment to the profits of an associated enterprise gives rise to double taxation, Article 25 (Mutual Agreement Procedure) allows adjustments to be made to the taxable profits of the other associated enterprise to the transaction in cases which cannot otherwise be remedied under the treaty. This is to be done by referral to "competent authorities" of the Contracting States to the treaty. In practice this means that, where this Article is invoked by a taxpayer in one State, negotiation takes place between the taxation authorities in that and the other State to agree how transfer pricing should be determined on the transaction in question between the associated enterprises, by reference to the OECD transfer pricing guidelines.

The published OECD Transfer Pricing Guidelines propose a number of methods at arriving at an arms' length price being: comparable unconnected price (CUP); resale minus; cost plus; profit split; and transaction net margin method.

Specific Transactions

(1) Loans to EHL

UK transfer pricing legislation includes specific provisions relating to securities issued by one company to another where the two companies are "affected persons" and are under common control or one controls the other. Securities include those which do not create charges over assets. The effect of the legislation is to extend the scope of transfer pricing to include consideration of

(a) the overall level of the borrowing company's indebtedness;

(b) whether the loan would have been made between the companies if they had been at arms' length;

(c) the rate of interest charged on the loan.

This means that in considering whether and to what extent a borrowing company should have a tax deduction for interest payable on a connected party loan, one must consider: whether the issuing company ie the borrower is thinly-capitalised (ie its debt: equity ratio); whether the loan would be made at all; and also the rate of interest on the loan. This can lead to disallowance of interest on that portion of the loan which is deemed to be excessive, and also a disallowance of a part of the remainder of the interest if the rate of interest is excessive.

There are no strict safe harbours for deciding whether a company is thinly-capitalised although as a rule of thumb a debt: equity ratio of not more than 1:1, and interest cover (ie the multiple of interest costs represented by profits) of at least 3:1 are generally considered useful starting points. Equity includes share capital and undistributed profits.

In considering possible transfer pricing implications for EuroAmerican Holdings Ltd (EHL), the first point to consider is whether the $100 million loans from its US parent company would have been made if the companies had been acting at arms' length, whether in consequence of the loans EHL is thinly capitalised and thirdly whether the rates of interest on the loans are excessive.

On the basis that EHL makes profit on its activities of borrowing and lending, it can be argued that the rate of interest paid on the US borrowings is not excessive**.** If any interest is disallowable it must be reflected in EHL's self assessment. However, the disallowed interest does not cease to be treated as interest for other purposes (eg tax deduction at source) under UK law.

Turning to the loans to the subsidiary companies by EHL, these are subject to similar tests (thin capitalisation and interest rates) for each subsidiary separately.

If a disallowance of interest is required in a UK subsidiary, EHL can claim a corresponding adjustment to reduce its profits by a corresponding amount**.** Any balancing payments, up to the amount of the adjustment, between a subsidiary and EHL to compensate for the adjustment are ignored for tax purposes**.** Conversely if the interest is less than an arms' length rate, the profits of EHL are increased by way of recognition of imputed additional interest up to an arms' length rate, and the profits of the UK subsidiary can be reduced on a claim for corresponding relief.

If the subsidiary is non-UK resident and not a controlled foreign company (CFC), then EHL's profits can be increased if the interest it is charging on the loan is insufficient ie not an arms' length rate. However, if the interest charged to a non-UK subsidiary is held to be excessive and disallowed as a tax deduction by the taxing authorities in that company's territory under the local transfer pricing rules, EHL cannot make a claim for a corresponding reduction in its taxable income, because no adjustment would have been made under UK transfer pricing legislation on the non-UK company's profits. An adjustment might be possible under the double tax treaty on a competent authority claim to HMRC.

If the subsidiary company suffering a disallowance under UK legislation is a CFC whose profits are apportioned to and taxed on EHL, EHL will be able to claim a corresponding deduction under the UK legislation.

(2) Swiss bank loan

The proposed loan from the Swiss bank to EHL is not in itself a transaction between parties under common control or parties where one controls the other, and as such the transaction in itself does not fall within the UK transfer pricing rules.

However, UK transfer pricing legislation also applies to a series of transactions. The definition of a series of transactions includes arrangements where the transactions making up the series are not directly between the affected persons. Accordingly, the parent company guarantee given to the Swiss bank together with the loan to EHL from the Swiss bank is a series of transactions.

As EHL and EuroAmerican Inc (EAI) are connected then the loan from the Swiss bank falls within transfer pricing provisions. The loan, together with the existing loan from EAI to EHL, will be considered from a thin capitalisation and interest rate perspective, and EHL could suffer disallowances of interest paid either to EAI or to the Swiss bank, as in (1) above.

(3) Eurocash Ltd

The loan from the dormant company to EHL is potentially subject to transfer pricing as the dormant subsidiary will gain a tax advantage because it will not charge interest and so its tax liability is reduced in consequence. There is an exemption for dormant companies from transfer pricing adjustments, where the dormant company is the "advantaged person" under UK legislation, but only for those companies which were dormant prior to the introduction of the current transfer pricing legislation in March 2004 (FA 2004) and have remained so since then. In the present case, the company in question will not qualify for this exemption as it will only become dormant now, on the transfer of its trade, and was therefore not dormant in March 2004 and since then.

As such, it will have to make UK tax returns showing imputed interest receipts based on the interest that would have been paid by EHL on the loan if made on an arms' length basis, and it will be liable to tax on those amounts. EHL will be able to claim a corresponding reduction in its taxable profits so that, from a taxable profits point of view, the position for the group is neutral.

(4) Expansion in Poland

The UK could provide financial support to the Polish subsidiary in a number of ways. EHL could finance the company with a combination of equity, and low or interest-free debt. The UK manufacturing company could provide its goods on favourable terms such as selling at below an arms' length price, and/or on a sale-or-return basis, and/or allowing the Polish company to buy on favourable credit terms with long payment terms and no/low interest charges on unsettled balances. Support could also be provided from the UK by way of direct support payments.

Any of these methods are prospectively susceptible to a transfer pricing adjustment in the UK insofar as the transactions in question are not what would have been put in place between parties acting at arms' length and, in consequence, the UK company or companies enjoy a UK tax advantage through their taxable profits being lower than they would have been on an arms' length basis.

Transfer pricing adjustments on low rate loans would take the form of additional imputed interest in the UK, whereas under-priced sale of goods would be subject to uplift to arms' length price. Direct support payments could be subject to disallowance in whole or in part.

In the present situation, support is being given to the Polish company to enable it to penetrate a new market, and in consequence create an additional outlet for the goods manufactured in the UK. To that extent, it might be that the financial support provided is the same as would be given to an independent distributor to enable it to establish its market before moving to full pricing structures.

You should gather evidence to demonstrate that support is given in your industry, or indeed by your group, and failing that by similar industries, to distributors in start-up situations. Such evidence can be used to inform and then endorse your chosen methods of providing financial support to your Polish subsidiary. The most compelling evidence would be in respect of support that you, or competitors, have given to independent distributors in similar situations, as this would establish a comparable unconnected price (CUP). If that is not available, you should move on to consider other pricing models included in the OECD Transfer Pricing Guidelines such as re-sale minus, cost plus and profit split, as a means of determining the price at which goods should be sold to the Polish subsidiary.

Answer 5

Part (1)

Although Research Ltd is currently a SME, it will become a large company for R&D purposes once acquired by Health plc because the SME rules can only apply where less than 25% is owned by a non SME. As a result, the R&D rules for large companies will apply to the whole accounting period to 31 March 2012.

[See spreadsheet for calculation of the enhanced R&D relief]

Qualifying expenditure	£(000)	*Notes*
Project A		
Staff costs	150	
Payments to Cambridge University	75	A UK institution of higher education is a qualifying body
Payments to externally provided workers (£100K × 65%)	65	
Payments made to retired professor	0	Does not qualify as a payment to an externally provided worker
	290	
Enhanced relief (£290k × 30%)	**87**	
Project B		
Staff costs	200	
Software costs	25	
Payments to sub-contractor	0	65% would have qualified whilst Research Ltd was an SME but payments do not qualify once it is a large company (unless sub-contractor is a qualifying body)
Contribution to independent research	20	Company is connected with its controlling shareholder who is a member of the firm. Payments made before 31 December 2011 do not qualify for relief
	245	
Enhanced relief (£245k × 30%)	**73.5**	

Part (2)

The questions to include in the due diligence requests should include the following:

Project A:

- Confirmation that the company that contracted the research and development to Research Ltd was itself a large company
- The expenditure by Research Ltd is attributable to relevant research and development undertaken by Research Ltd itself
- Confirmation that the staffing costs relate to cash amounts or expenses paid to, or pension contributions paid in respect of, employees or directors of Research Ltd because of their employment or on the consequential employers' NIC

- Confirmation that the research subcontracted out to Cambridge University is undertaken by the University itself, and not subcontracted out by it to others
- Confirmation that, in respect of the payments made to the computer agency, the programmers are all individuals, none are directors or employees of Research Ltd and the programmers are subject to supervision, direction and control by Research Ltd and the computer agency is not connected with Research Ltd

Project B:

- The expenditure by Research Ltd is attributable to relevant research and development undertaken by Research Ltd itself
- Confirmation that the staffing costs relate to cash amounts or expenses paid to, or pension contributions paid in respect of, employees or directors of Research Ltd because of their employment or on the consequential employers' NIC
- In relation to the contribution to the independent research on cancer drugs, the relevant research has not been subcontracted out to the partnership by another company, person or firm and the research is related to a trade carried on by Research Ltd

Part (3)

Subject to agreement by the other parties to the various arrangements and to commercial considerations, consideration could be given to the following to enhance the amount of the R & D tax relief available:

In relation to Project A

- Re-engage the retired professor as an employee of Research Ltd or employ his services through an agency rather than engage him as a self-employed worker.
- Ask computer agency if it is happy to provide details of its profit element on the computer programmers and, if so, consider whether it would be beneficial to elect for connected persons treatment.

In relation to Project B

- Delay the payments for the contribution to the independent research to the partnership until after 31 December 2011 when no member of the partnership will be connected with Research Ltd.
- Consider the terms on which the research is contracted out to the independent SME to see if the contractual arrangement can be changed for the future so that the research and development is no longer contracted out by Research Ltd but, for example, Research Ltd undertakes the research and development itself and either employs the SME's staff itself or engages them through the SME (or another staff provider).

Answer 6

The loans from the banks to Star Ltd and to Epsilon Ltd and the loan from Metropole Ltd to Epsilon Ltd would all appear to be loan relationships as they are money debts arising from a transaction for the lending of money.

There are two instances where the loan relationship legislation deems there to be a release of a liability under a debtor loan relationship. A debtor loan relationship is one where the loan is a liability in the balance sheet. Where either of these circumstances apply, the credit arising in the debtor company on the deemed release has to be brought into account for tax purposes.

Acquisition of creditor rights by connected company at undervalue

The first instance applies where a company (Metropole Ltd) acquires a debt from an unconnected creditor (the bank) and immediately after that acquisition Metropole Ltd is connected with the debtor company (Star Ltd and Epsilon Ltd) (whether such connection arises by virtue of acquiring shares at the same time as the debt, or whether the debtor and Metropole Ltd were previously connected) and the pre-acquisition carrying value of the debt (being the original amount of the liability in the accounts of the debtor) exceeds the consideration which Metropole Ltd has paid for the debt. In such circumstances, under s.361 CTA 2009 there is a deemed release of the debt in the amount of the excess, so that the difference between the face value of, and the amount actually paid for, the debt is treated as released and therefore constitutes a credit taxable on the debtor.

Prima facie there will therefore be a deemed release of £9m of the bank loan in Star Ltd on the acquisition of the debt by Metropole Ltd from the bank. Metropole Ltd is connected with Star Ltd as Star Ltd is a wholly owned subsidiary of Metropole Ltd and will remain connected with Star Ltd immediately after the acquisition of the debt. Similarly, if the acquisition by Metropole Ltd of the shares in Epsilon Ltd occurs before or simultaneously with the acquisition by Metropole Ltd of Epsilon Ltd's bank debt, there will be a deemed release of £13m of the bank loan in Epsilon Ltd. With respect to Epsilon Ltd in theory it might be possible to avoid this charge in Epsilon Ltd by arranging for the bank loan to be acquired first, and then the shares in Epsilon acquired later. However, in those circumstances, s.362 CTA 2009 will apply with the result that there would still be a deemed release of £13m of the debt by Epsilon Ltd.

For acquisitions of debt after 14 October 2009, an exception to the deemed charge (referred to in the legislation as the 'corporate rescue exception') applies in the following circumstances:

- The acquisition by the new creditor (Metropole Ltd) is at arms' length;
- There has been a change in ownership of the debtor company (Star Ltd or Epsilon Ltd) in the period beginning one year before and ending 60 days after the acquisition of the debt;
- It is reasonable to assume that but for the change in ownership the debtor company would have become insolvent; and
- It is reasonable to assume that the new creditor would not have acquired the debt but for the change in ownership.

So long as the change in ownership of Epsilon Ltd takes place in the period beginning one year before and ending 60 days after the acquisition by Metropole Ltd of the bank debt, the corporate rescue exception should apply to Epsilon Ltd with the consequence that there is no deemed release of the debt in Epsilon Ltd that would need to be brought into account for tax purposes. However, if there were to be any subsequent waiver or release of the loan by Metropole Ltd, Epsilon Ltd would, at that time, be required to bring into account for tax purposes the amount that would have been taxed on the deemed release of the debt if the corporate rescue exception had not applied.

The corporate rescue exception will not however apply to Star Ltd since there has been no change of ownership of Star Ltd in the required period. There will therefore be a deemed release of £9m of bank debt within Star Ltd (with the consequence that £9m is brought into account for corporation tax purposes as income in calculating Star Ltd's trading profits) in the circumstances you outline.

To avoid this charge is would be necessary to revise the proposed arrangements so that they satisfied the conditions for either the equity-for-debt exception or the debt-for-debt exception but this would change the fundamental commercial effects of the arrangements. To fall within the equity-for-debt exception it would be necessary for the consideration for the acquisition of the debt from the bank to be an issue of ordinary shares in Metropole Ltd, an issue of ordinary shares in Star Ltd or the issue of ordinary shares in any other company connected with Metropole Ltd. To fall within the debt-for-debt exception it would be necessary for the bank to agree to release the debt due from Star Ltd in exchange for a new loan made to Metropole Ltd where the amount of the new loan to Metrople Ltd and its terms are substantially the same as those of the original loan to Star Ltd.

The impairment provision in Metropole Ltd in the accounting period ended 30 June 2011 in respect of the loan due from Epsilon Ltd will be deductible for corporation tax purposes within Metropole Ltd but only to the extent that the impairment arose after Epsilon Ltd previously ceased to be connected. If you have not already retained evidence, evidence should be retained to show that at the time when Metropole Ltd previously disposed of Epsilon Ltd, no impairment provision would have been required.

Parties becoming connected where creditor's rights subject to impairment adjustment

The second instance where a deemed release of a debtor relationship occurs is where the identity of the creditor remains the same (Metropole Ltd), but the creditor changes from being unconnected to connected, in circumstances where the amount that would have been the carrying value of the loan relationship asset in the accounts of the creditor if a period of account had ended immediately prior to the companies becoming connected would have been adjusted for impairment.

The deemed release is of an amount equal to the impairment adjustment that would have been made. Therefore, if Metropole Ltd were to reacquire Epsilon Ltd as proposed, there will be a deemed release of the whole of the debt of £5m within Epsilon Ltd with the consequence that it will need to bring into account for corporation tax purposes £5m income in calculating its trading profits. This will effectively counteract the corporation tax relief obtained in the accounting period ended 30 June 2011 in Metropole Ltd on the impairment loss. Anomalously, even if part of the impairment loss in Metropole Ltd on the loan to Epsilon Ltd arose during the period when they were previously connected (and so there was a corresponding reduction in the corporation tax relief available in Metropole Ltd on the impairment loss) there would still be a deemed release of the whole loan within Epsilon Ltd on it becoming connected with Metropole Ltd again on the proposed reacquisition.

The subsequent waiver of the loan should be corporation tax neutral, no relief being available in Metropole Ltd and no credit being taxable in Epsilon Ltd.