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Changing tack

Features

Corporation Tax

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Pete Miller suggests that there has been a change of approach to the associated companies rules and the small profits rate.

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Key Points

- *The background to the associated companies rules.*
- *The unfairness of the mechanistic approach.*
- *What happened to the requirement for relevant tax planning arrangements?*
- *It is planned that the legislative proposals are to be changed to match the HMRC guidance.*
- *Should we return to the original plan?*

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Following a consultation process that ended in February this year, HM Treasury and HMRC have published a response document: Simplification review: the associated company rules as they apply to the small profits rate of corporation tax -- a summary of consultation responses (see www.lexisurl.com/SimpResp).

Despite not being officially a consultation document, comments are invited (albeit without a time limit as yet) and the document has new draft legislation that is completely different from the original proposals.

Background

The rate of corporation tax applicable to a company is based on the company's profits for an accounting period, with the 'small profits rate' (CTA 2010, s 18 and all references are to this Act unless otherwise specified) charged where the profits do not exceed £300,000 (the lower limit, s 24(2)(a)).

The main rate of corporation tax is charged where the company's profits exceed £1.5 million (the upper limit, s 24(2)(b)), and the marginal rate applies for profits in between the two limits (s 19). In order to prevent artificial fragmentation of a company's business into several companies, each of which would have a £300,000 lower limit and a £1.5 million upper limit, the associated companies rule reduces the lower and upper limits by dividing them by the total number of associated companies (s 24(3)). So, for example, if two companies are associated, then the lower limit is £150,000 for each company and the upper limit is £750,000.

In very broad terms, companies are associated if they are owned by the same person, if they are owned by people who are also business partners, or if they are owned by members of the same family.

These rules work completely mechanistically. Thus companies owned by, say, parents were automatically associated with companies owned by their children, and a company owned by a businessman was associated with a company owned by his business partner, regardless of the degree of actual commercial connection between the companies. This latter was a particular problem: historically, partners in large accountancy firms, for example, would not be able to claim the small profits rate of corporation tax, as they could not know who all their business partners were and how many of them might own companies, so it was impossible to say how many associated companies there were.

In the context of business partners, the position was addressed by FA 2008, s 27. This says that companies owned by business partners are not associated unless the partners have entered into tax planning arrangements designed to reduce the company's liability to corporation tax by increasing the small profits relief available. Given that the original policy objective was to prevent abuse of the small profits rate, this seemed a reasonable approach and, so far as I am aware, has worked well for the couple of years that it has been in force.

The current problem

*More recently, there has been consultation as to how to deal with the inherent unfairness of the rule in relation to families. The **Example** shows a situation where companies would be treated as associated when there is no connection between them but for the personal relationship between the shareholders.*

In the first consultation, which ended in February 2010, HMRC published draft legislation and guidance. The proposal was to extend the rule applicable to business partners to family members, too, so that companies owned by family members would be treated as associated only if there were relevant tax planning arrangements between the parties, designed to take advantage of the lower rate of tax.

*On the basis of such a rule, the facts in the **Example** would suggest that Jones Ltd and Jones Junior's company would not be treated as associated. This is because the reason they are different companies is that they are different businesses being run by different individuals, completely independently and without any relevant tax planning arrangements. It certainly seemed unlikely that HMRC could argue that Jones Junior's decision to use his own company, rather than starting his operations through his parent's company, could in any way be described as tax avoidance.*

This proposal seemed very sensible, particularly since it was already in operation for business partners. It would have allowed many more companies to claim the small profits rate of corporation tax, albeit at the expense of a slightly higher degree of uncertainty in terms of the operation of the anti-avoidance rule. But I, for one, felt this was a fair price to pay for increased fairness in the tax code.

A digression

*If I may digress briefly, this **Example** also highlights another issue that HMRC does not want to address. As we have seen, the associated companies rule operates by simply dividing the lower and upper limits by the number of companies that are associated.*

In **EXAMPLE 1**, we see that the operation of the rule means that Jones Ltd is unable to access the small profits rate simply because Jones Junior had incorporated a company to carry on an unrelated business. Suppose, however, he made no profits for the first couple of years: his £150,000 lower limit would be completely unused, but Jones Ltd will have a significantly increased tax bill.

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Example 1

Mr and Mrs Jones own Jones Ltd, a company that makes model aircraft kits. This company has been established for some time and makes profits of between £250,000 and £300,000 annually. There are no other associated companies and the company therefore usually pays tax at the small profits rate.

Jones Junior graduates from university with a degree in economics and sets up an economic consultancy company. For the first year or so of trading his profits are relatively small. Because the two companies (Jones Ltd and Jones Junior's company) are now associated, both of those companies now have a lower limit of £150,000 and an upper limit of £750,000.

For Jones Junior's company, this is less important, on the basis that his profits are low for the first couple of years of trading. But for Jones Ltd, this has a major impact, as now almost half the profits have fallen out of the small profits band and are taxed at the higher marginal rate, instead. This is despite the fact that there is no commercial link between the companies and so the only reason for them being treated as associated is the personal relationship between Mr and Mrs Jones and their offspring.

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A sensible associated companies rule would allow the companies that are associated to allocate the lower and upper limits between themselves in whatever proportions as they feel appropriate, in much the same way as companies can currently do with the annual investment allowance for capital allowances purposes. This does not seem to have been considered (although an alternative, whereby the rate of corporation tax would be based on the total profits of the associated companies (paragraphs 3.28, 3.29), was considered to be too difficult. But in the **Example**, a rule allowing companies to allocate the lower and upper limits would mean that the lower limit could be granted to Jones Ltd, by mutual election with Jones Junior's company, and the mere incorporation of a trading company by their son would not necessarily mean an increased tax bill for Mr and Mrs Jones' company. In practice this might be achieved in the same way as a group relief claim, or perhaps by simply apportioning the limits equally between the associated companies unless a joint election is made otherwise.

The original draft guidance

The problem with last year's consultation document was the draft guidance. This consisted mainly of examples intended to illustrate when HMRC considered that companies would be associated, under the proposed extended rule. But the examples given proposed some degree of commercial interdependence between the companies and concluded that, where such commercial interdependence was present, the companies were associated. The examples did not refer back to the requirement in the draft legislation that there be relevant tax planning arrangements, and my main criticism of the document was simply that HMRC's draft guidance treated companies as associated because of the degree of commercial interdependence without relating those examples to the proposed statutory words that required relevant tax planning arrangements. So my conclusion was that the proposed new legislation was fine, but that HMRC needed to ensure that their guidance reflected the statute.

The next stage

The new document was published in July 2010. It was clear from the responses to the consultation that 'there was wide support for the policy rationale behind the proposed new test.' (paragraph 3.2), albeit at the expense of an increase in uncertainty (paragraph 3.5). But by some bizarre upside down approach to tax policy making, paragraph 3.7 refers to the draft legislation as being 'inconsistent with the draft guidance'. Surely, the point was that the draft guidance was inconsistent with the proposed legislation and, if the test was right, then the guidance should follow. Unfortunately, or for reasons that are not explained, HMRC has felt it appropriate to amend the draft legislation to better reflect the examples in the draft guidance, rather than rewriting the examples to demonstrate situations where there might be relevant tax planning arrangements!

So, the new draft legislation amends the associated companies rule for both business partners and family members (in s 27) so that companies are associated only if there is 'substantial commercial interdependence' between them. There is then a draft statutory instrument to define the phrase 'substantial commercial interdependence' by reference to the three concepts of companies being 'financially interdependent', 'economically interdependent' and 'organisationally interdependent'.

I believe that this is the wrong test: the original anti-fragmentation rule was introduced as an anti-avoidance rule, to prevent artificial fragmentation of businesses. So it seems logical that a tax-avoidance motive test was the appropriate way to try to determine whether the small profits rate should be available. Clearly, the mechanistic application of the original tests for associated companies often gave unfair results, where there was no commercial interdependence between companies and they were associated only through an accident of business or birth, so there is some argument for a test based on the degree of commercial interdependence. But the new proposal can operate just as mechanistically, to give equally unfair results. I feel that extending the current partners rule, targeted at relevant tax planning arrangements, is the better approach and more in line with the original policy objective.

Documentary examples

To demonstrate this point, let's look at one of the examples in the document. According **EXAMPLE 2** at CTM03790: Interdependence -- economic interdependence, 'the two companies share a common economic goal with a common customer base and mutually beneficial activities' as well as being 'organisationally interdependent', so the example considers the companies to be associated. On face of it, I would agree with that analysis in terms of the proposed tests of commercial interdependence. But I would argue that this is an archetypal business fragmentation scenario, with what is basically a single economic unit owned by one family being separated into two companies, so this example could be seen as demonstrating relevant tax planning arrangements too, and we would have achieved the same result with the test that was originally proposed.

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Example 2

CTM03790: Interdependence -- economic interdependence C is the major shareholder in Company Y and a 49 per cent shareholder in Company Z. The two companies operate a large public house, which is very popular for family dining as well as having a thriving wet trade. Company Y handles wet sales and Company Z, which is run by the majority shareholder, C's wife, manages the catering operation. Mrs C has financed the purchase of the assets of the catering business from a family legacy and a loan to Company Z which she is guaranteeing personally. Both businesses are insured separately. Each business fully meets its own costs, and the catering business is charged a commercial rate for the use of the shared premises, employees and facilities. Although there is no cross subsidy, the two companies share a common economic goal and premises, and Company Z would not be viable without Company Y. The two companies are accordingly 'associated'.

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Let's play with the example a bit and change it so that company Z, which carries on the catering business, is owned by Mrs D, who is not related to Mr C. The companies have the same degree of commercial interdependence as in the CTM03790 example, but they would not be associated simply because Mr C and Mrs D are not related. But Mrs D would have set up her own company to run her catering business because she has no personal connection to Mr C, and there would be no relevant tax planning arrangements, either.

Now, let's suppose Mr C and Mrs D were to marry (assuming that they are free to do so). According to HMRC's example, they are now related to each other, and there is substantial commercial interdependence between the companies, so that now they should be treated as associated. What we see is the test operating mechanistically to give an unfair result, given that the businesses were run through separate companies at a time when Mr C and Mrs D were not associated themselves. Similarly, if instead of marrying, Mr C and Mrs D became partners in another business venture, we would see the same mechanistic result, that companies Y and Z have become associated.

On the other hand, let's look at what happens if the test is that of there being relevant tax planning arrangements: since the companies are not associated while Mr C and Mrs D were not married or were not business partners, the companies should not become associated, as there are clearly no relevant tax planning arrangements. (I don't generally view marriage as a relevant tax planning arrangement.) So the originally proposed motive test gives a fairer and more logical result, which is more in line with the original policy, than that of the newly-proposed test of commercial interdependence. Furthermore, a motive test leaves scope for HMRC or, where appropriate, the tribunals and the courts, to exercise discretion and come to a proper view based on the facts. (One might ask how this ties in with the published view of the Government to promote marriage, since the proposed legislation actively discourages it!)

The role of the judiciary

This brings me to another issue that I dislike in the current proposals. It seems to me that the phrase 'substantial commercial interdependence' is reasonably clear in its meaning. If this is to be part of the test for association, this is the sort of phrase that permits HMRC, the tribunals and the courts to consider whether companies are substantially commercially interdependent based on the facts as presented to them.

I do not see any need for regulations to give what are, in my view, somewhat trite definitions of financial, economic, or organisational interdependence. In fact, I feel that these definitions will restrict the ability of HMRC and the judiciary to decide for themselves what is meant by 'substantial commercial interdependence'. Nor do I see that these very brief definitions are likely to materially decrease the uncertainty inherent in the proposed test.

Conclusion

Overall, let me reiterate that I, along with most other observers, absolutely agree that reform of the associated companies rules is long overdue. However, I am very strongly of the view that the original approach, of applying a tax-avoidance motive test, is far closer to the original policy objectives and is a better understood rule, having been in operation for a couple of years already in the partner context. I cannot see why the new proposals are trying to make the rule conform to the original draft guidance, rather than making the guidance conform to what many of us thought was a perfectly acceptable rule.

It may be that my preference for an anti-avoidance rule, rather than a mechanistic rule of commercial interdependence, is not shared by everyone. Either way, it is important that the legislation we get reflects the views of business and tax professionals, so far as possible within the constraints of tax policy, and I would urge everyone to consider responding to the new proposals as soon as possible. At the moment, no closing date for consultation has been given although the document makes it clear that it is intended that the legislation be introduced in Finance Bill 2011 to take effect from 1 April.