The Chartered Institute of Taxation
South West England Branch

Advanced corporation tax issues - 2013

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Exeter
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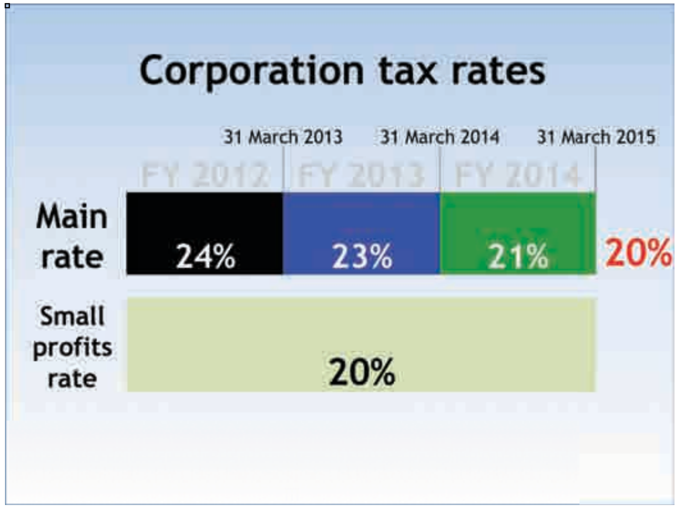
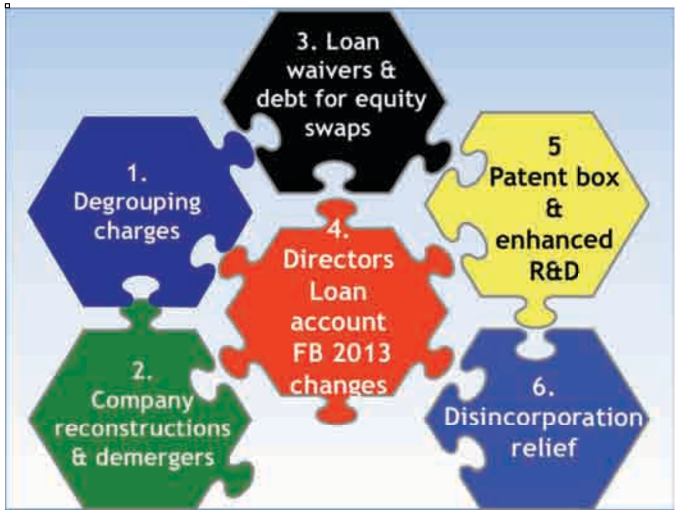


Introduction - Corporation tax rates

In the Budget 2013, George Osborne announced further reductions to corporation tax rates, which now means that the UK has one of the lowest rates of the major western economies.

The 'ritual flagellation' of Starbucks, Amazon and Google before the before Parliament's Public Accounts Committee in November 2012 shows that global businesses can easily locate the activities to benefit from low tax rates. The further reductions in the corporation tax rates have clearly been made to improve the UK's attractiveness as a place to do business.

George Osborne announced that the UK will have a single corporation tax rate of 20% from 1 April 2015.


3. Loan waivers & debt for equity swaps
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2. Company reconstructions & demergers
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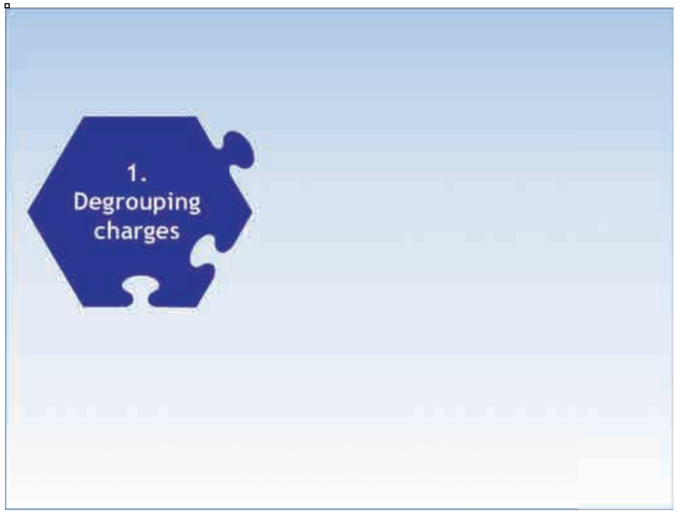
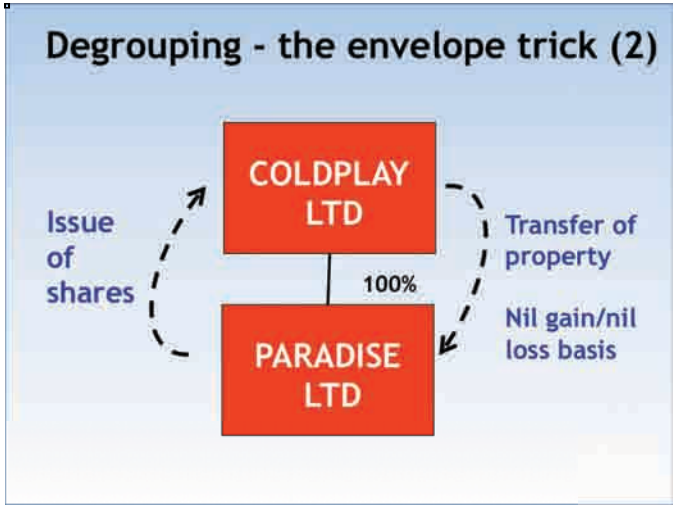

1. Degrouping charges

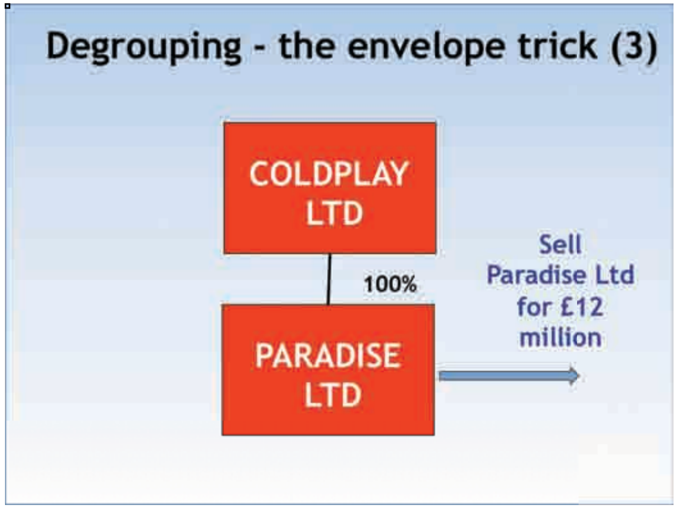
1.1 Background to degrouping charges

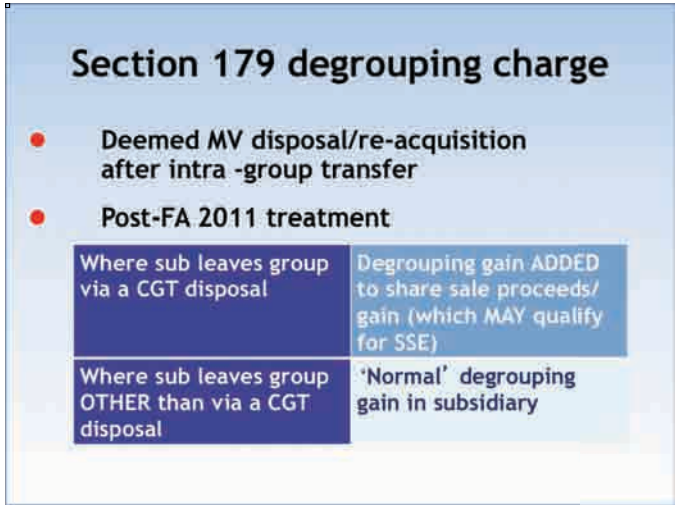
The degrouping charge legislation were first introduced in 1968 to counter the so-called ‘envelope trick’, which enabled corporate groups to sell assets to third parties without incurring a taxable gain. The envelope trick entailed first transferring an asset into a subsidiary under the ‘no gain/no loss’ rule (for intragroup transfers) in consideration for shares or debt. Since the shares had a base cost equivalent to the base cost of the asset, it was then possible to sell the subsidiary (which held the asset) with little or no capital gain.

Such planning techniques are now caught by the degrouping charge rules in (what is now) s179, Taxation of Chargeable Gains Act 1992(TCGA 1992).This is because s179(4) TCGA 1992 requires a deemed disposal (and re-acquisition) of any asset which is transferred into a subsidiary within six years of the subsidiary leaving the group (typically via a sale). A degrouping charge only applies where the relevant asset is still held by the subsidiary when it leaves the group.

Unfortunately, the mechanical nature of the provisions does not distinguish between envelope trick type cases and commercially motivated transactions, and this has often caused problems for corporate groups seeking to sell subsidiaries after a group restructuring exercise. Furthermore, since the introduction SSE regime in 2002, shares in a subsidiary would often be sold ‘tax-free’ under the SSE but (**prior** to FA 2011) that subsidiary would still have been exposed to a degrouping tax charge.







1.2 FA 2011 degrouping charge procedure

Sch 10, FA 2011 introduced some radical changes to the mechanics of the degrouping tax charge.

The actual degrouping gain/loss is still calculated on the same basis as before, i.e. the transferee subsidiary is deemed to sell and reacquire the relevant asset at its market value immediately after the previous intra-group transfer. However, where the transferee company leaves the group due to a disposal of its shares (or shares in another group company) – as will typically be the case – then the degrouping gain is added to the consideration received for the disposal of the shares. On the other hand, if the deemed degrouping disposal gives rise to a capital loss, this is **added** to the base cost of the shares being sold (s179(3D), TCGA 1992).

One very important consequence of these changes is that where the sale of the subsidiary (or other group company) qualifies for the SSE, this will also ensure that the degrouping gain obtains the benefit of that exemption.

Where SSE is not available – for example, if the subsidiary is sold out of an investment group – the FA 2011 degrouping charge treatment still applies. In such cases, the taxable gain on the sale of the subsidiary, including the degrouping gain, would fall on the seller (subject to any reallocation election under the revised s171A ,TCGA 1992).


FA 2011 degrouping charges - 1
GLAM ROCK HOLDINGS LTD
SWEET LTD
WIZZARD LTD
MUD LTD
May 2011 -
transfer of property
MV = £1.2m

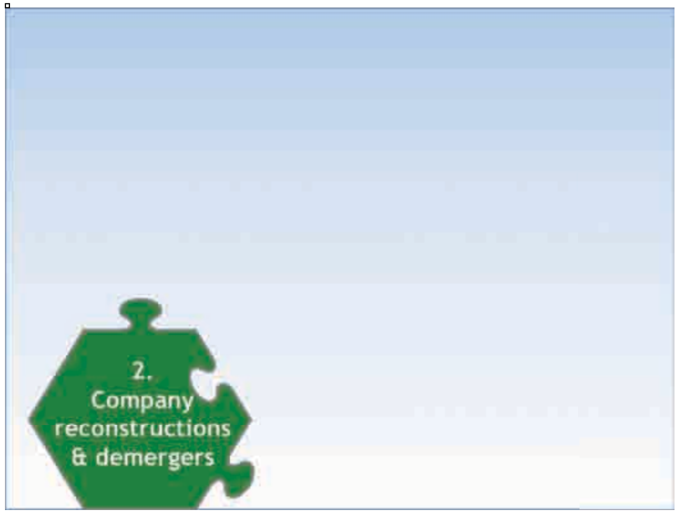

FA 2011 degrouping charges - 2
GLAM ROCK HOLDINGS LTD
SWEET LTD
WIZZARD LTD
MUD LTD
Sale of Wizzard Ltd
£2.5m

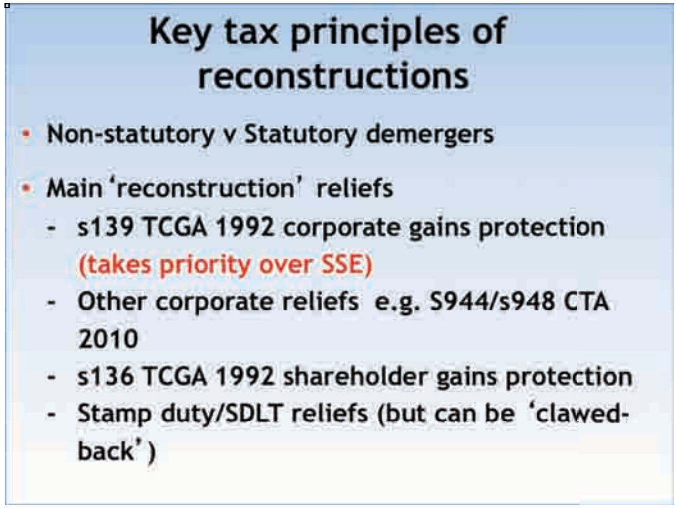
Sale of Wizzard Ltd - degrouping gain computation - 1

Degrouping charge	£'000
Deemed MV consideration (May 2010)	1,200
Less: Base cost	(500)
Indexation (£500,000 x 0.57)	(285)
Degrouping gain	415

Sale of Wizzard Ltd - capital gains computation - 2

Share sale	£'000
Share sale proceeds	2,500
Degrouping gain	415
Total sale consideration	2,915
Less: Indexed base cost	(450)
Gain exempt under SSE	2,465





2.1 Non-Statutory Demergers – s110 Insolvency Act 1986

A non-statutory demerger involves winding up the company with the relevant businesses or subsidiaries being distributed to a new company/ companies owned by all/or some of the shareholders under the procedure laid down in Section 110 Insolvency Act 1986.

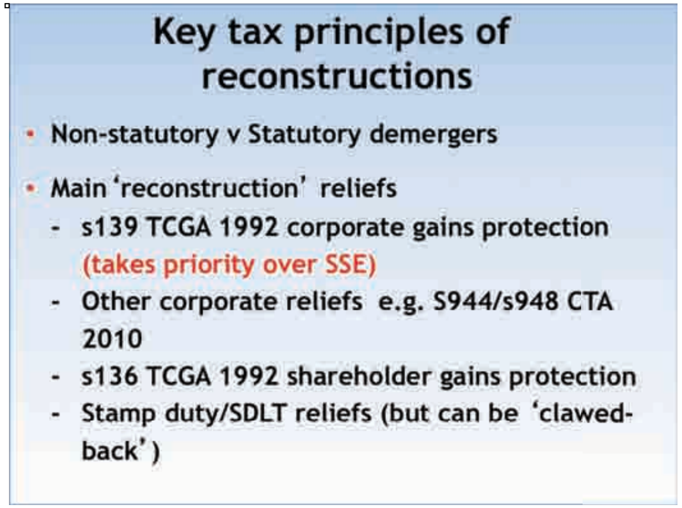
The liquidation is required to prevent the shareholders suffering a tax charge on an 'income' distribution under s1030 CTA 2010 (previously ICTA 1988 s209).

A non-statutory form of demerger is normally used for reconstructions which do not meet the detailed qualifying conditions for a statutory demerger, for example:

• Where an investment business (such as property letting) is being demerged, (the statutory demerger legislation only allows the splitting of *trades)*.

• Where there is an intention to sell off one or more of the demerged businesses (this is not permitted under the statutory demerger legislation).

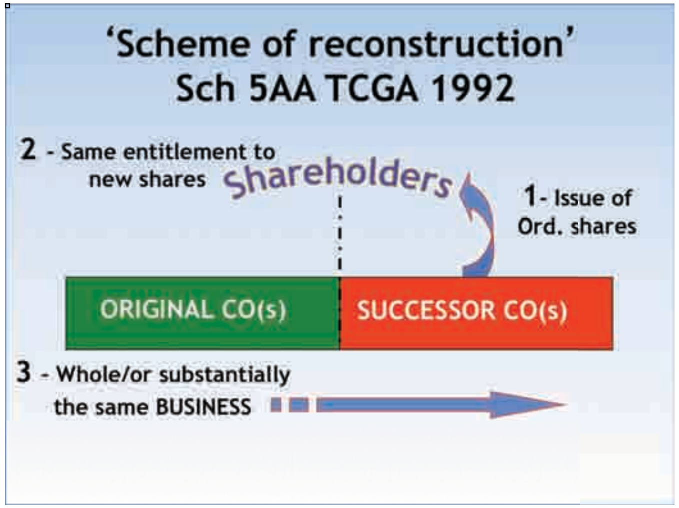
• Where the company has insufficient distributable reserves to declare a dividend in specie equal to the underlying book value of the assets/or subsidiary transferred.



2.1 Non-Statutory Demergers – s110 Insolvency Act 1986

The transferor company and the shareholders should obtain capital gains protection under a 'non-statutory' demerger by ensuring that the reconstruction reliefs in s139 and s136 TCGA 1992 apply.

The shareholder and company reconstruction reliefs in s139 and s136 TCGA 1992 respectively both require a 'scheme of reconstruction'. Before the FA 2002 changes, it was generally necessary to ensure that any contemplated corporate reconstruction or demerger constituted a 'scheme of reconstruction' based on established (stamp duty) case law and Revenue practice (including SP5/85). However, the application of the SP5/85 'concessionary' treatment was successfully challenged in the case of *Fallon v Fellows [2001] STC 1409.* To provide greater certainty, FA 2002 introduced a statutory definition (from 17 April 2002).



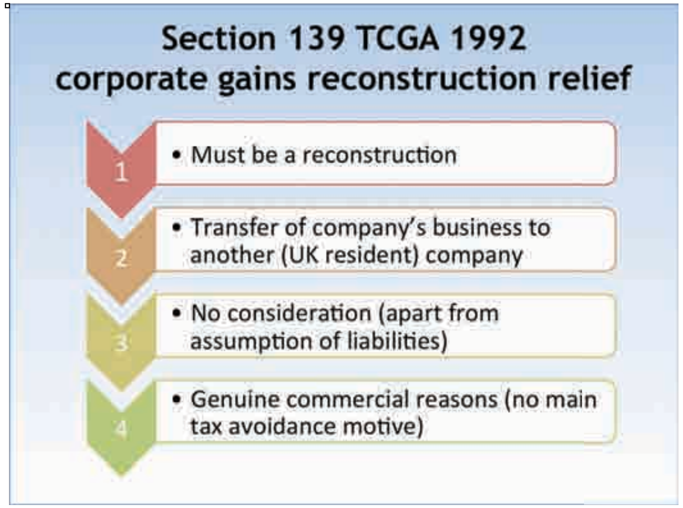
2.2 Scheme of reconstruction under Sch 5AA TCGA 1992

Under the statutory rule in TCGA 1992 Sch 5AA, a scheme of reconstruction contains the following key elements:

• Only the ordinary shareholders of the relevant business must receive ordinary shares under the scheme i.e. no one else must be entitled to receive new shares.

• The proportionate interests of the shareholders before and after the reconstruction must remain the same.

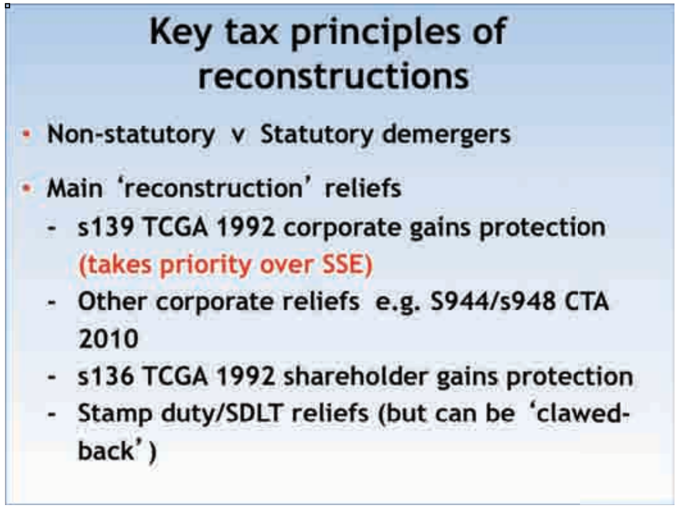
• The business previously carried on by the 'original' company or companies must be carried on by one or more successor companies (*unless the scheme is carried out under* a compromise or arrangement under CA 1985 s425 (or equivalent)).



2.3 Section 139 TCGA 1992 corporate gains reconstruction relief

Corporate gains on chargeable assets transferred to another company on a reconstruction are dealt with on a non gain/no loss basis. The transferor company will obtain corporate gains reconstruction relief provided, inter-alia, it does not receive any consideration for the transfer of the assets (except for the assumption of any liabilities)

A 'reconstruction' disposal of shares in a 75% subsidiary may potentially qualify for the Substantial Shareholdings Exemption (SSE). However, the no gain/no loss treatment under s139 TCGA 1992 will override the SSE relief (para 6 Sch 7AC, TCGA 1992).



2.4 Section 136 TCGA 1992 shareholder gains reconstruction relief

The shareholders are treated as not making any CGT disposal of their shares in the transferor company (under the capital distribution rule in s122 TCGA 1992).The shares issued by the new 'successor' companies on the reconstruction 'step into the shoes' of the original transferor company, and thus pick up the original base cost.

2.5 Tax clearances and genuine commercial purpose test

Both s139 and s136 reconstruction reliefs are subject to a 'bona fide commercial purpose' test, for which advance HMRC clearances can be obtained (Ss 137, 138 & 139(5) TCGA 1992).

2.6 Other key reconstruction reliefs

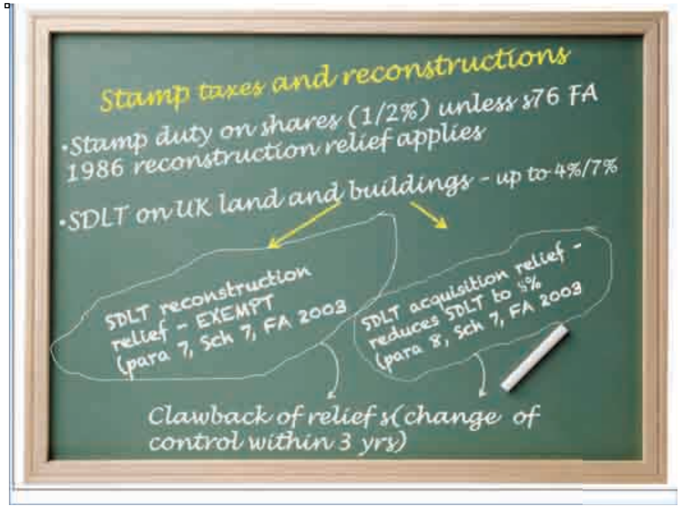
Certain 'succession' or reorganisation provisions may apply to provide relief or the carry over of losses, for example:

•Continuity of capital allowances (ss 569 CAA 2001 & s948 CTA 2010 (or s343 (2) ICTA 1988).

•Carry forward of unused trading losses (s944 CTA 2010 (or s343(3) ICTA 1988)).

•Stamp duty and stamp duty land tax (SDLT) (ss75-76, FA 1986, paras 7-9, Sch 7, FA 2003).

•VAT (Art. 5 VAT (Special Provisions) Order 1995).



2.7 Stamp duty and SDLT reliefs

Stamp duty and/or stamp duty land tax (SDLT) will usually be a significant factor in structuring a reorganisation - the failure to obtain relief on a reconstruction involving assets is likely to prove expensive. SDLT only arises on the transfer of UK land and property.

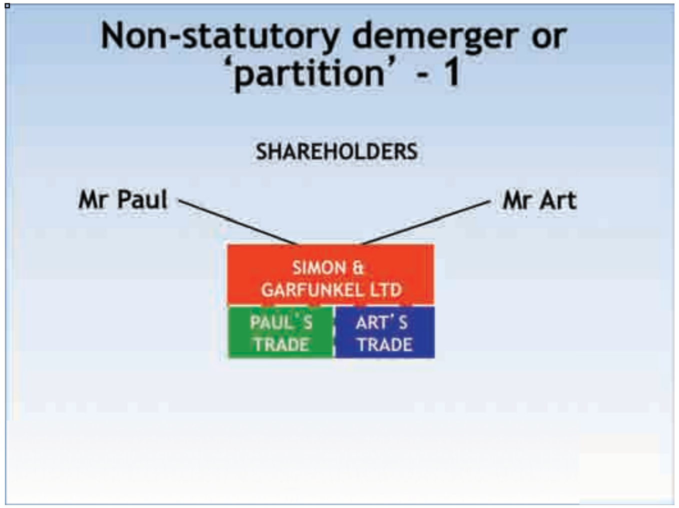
•If there is a 'pure' reconstruction with the demerged businesses/subsidiaries remaining under the same 'common' (mirror-image) ownership, there is normally complete exemption from stamp duty/SDLT (s75 FA 1986, para 7, Sch 7, FA 2003)

•Where the share ownership is split, with the businesses being owned by different shareholder groups, it should be possible to obtain a reduced stamp duty/SDLT charge under the relevant 'Acquisition relief' provisions (s76 FA 1986, para 8, Sch 7, FA 2003).

Acquisition relief enables the relevant assets to be transferred on a transfer of business at a reduced rate of 0.5% (this relief is not essential for *share transfers as they only* attract duty at 0.5% in the normal course of events). However, the transfer of *investment properties* does not qualify for this relief, and therefore attract SDLT at the full rate (maximum 4% for properties worth more than £500,000).

•Certain preparatory transactions may create a substantial stamp duty/SDLT liability, for example the transfer of trading property held by the parent into the relevant subsidiary prior to its demerger. Stamp duty/SDLT intra-group transfer relief is denied as this would invariably be part of an arrangement involving the recipient subsidiary leaving the group (s42 FA 1930, para 1, Sch 7, FA 2003).

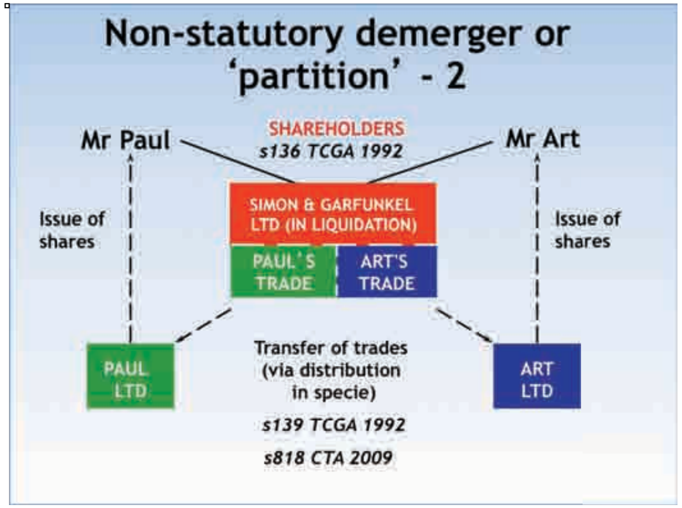
•Similarly, there will be a withdrawal of any SDLT intra-group transfer or acquisition relief where the recipient company is sold within three years (para 9, Sch 7, FA 1986).

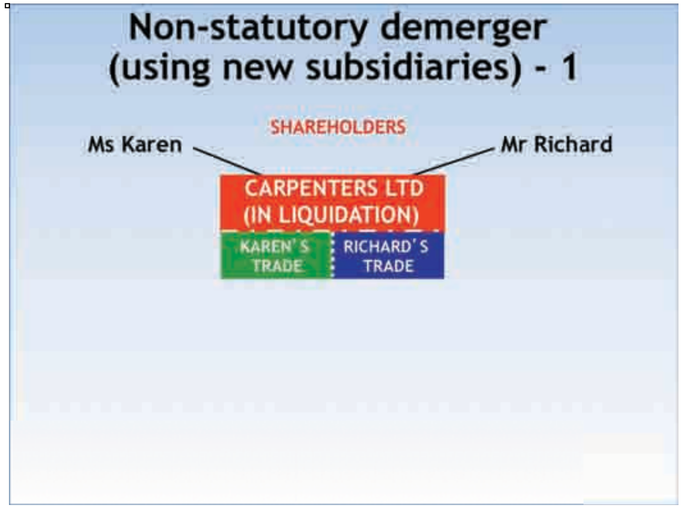


2.8 Non-statutory demergers

Under a non-statutory demerger, the liquidator enters into an arrangement under s110 IA 1986 whereby the trades are transferred to new companies in exchange for the issue of shares by the new companies to the original shareholders.

The 'simple partition' involves the transfer of the trade and assets to new 'stand alone' companies and may not satisfy the 75% common ownership test required under s941 CTA 2010 and therefore may involve the forfeiture of any unrelieved trading losses.

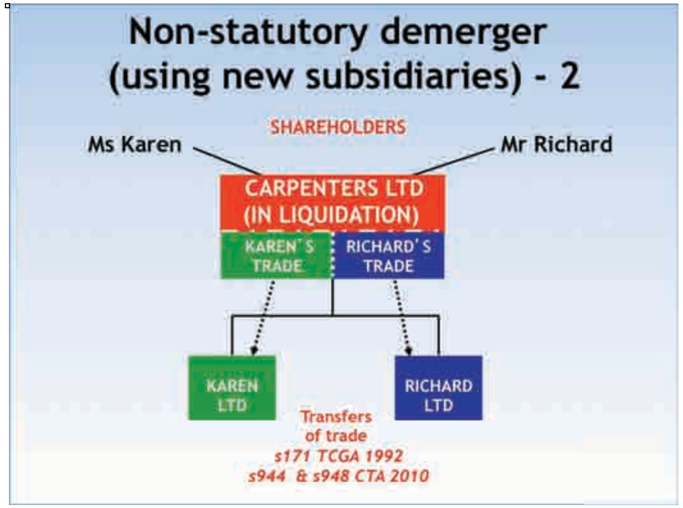


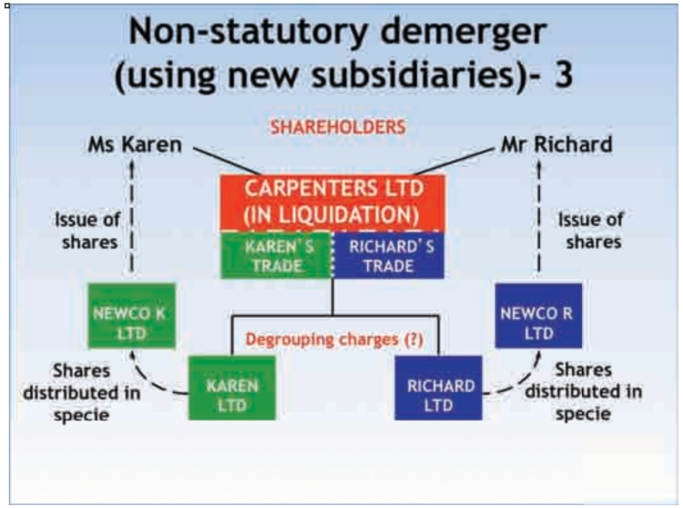


2.9 Non-statutory demerger with pre-s110 hive down of trades and degrouping issues

The s941 CTA 2010 problem in 2.8 could be overcome by hiving down the trades to subsidiary companies and then distributing the subsidiaries' shares in specie (as illustrated above).

Up until the introduction of the FA 2011, the distribution of the subsidiaries' shares would have triggered a s179 TCGA 1992 capital gains (or corresponding 'intangible regime') de-grouping charge (in respect of the assets hived down, notably goodwill).



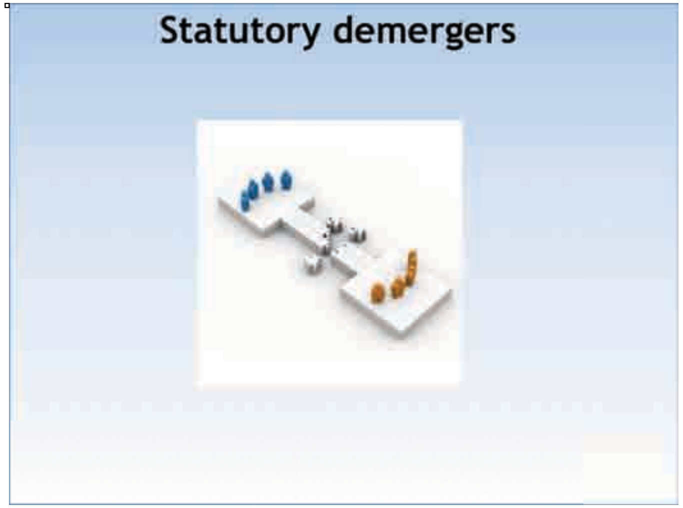


2.9 Non-statutory demerger with pre-s110 hive down of trades and degrouping issues (cont'd)

Under the FA 2011 degrouping rules, where a subsidiary company leaves a group (via a share disposal, which will usually be the case), the degrouping gain is normally added to the transferor company's disposal consideration (see new s179 (3D) as inserted by FA 2011). (For the sake of completeness, s139 TCGA 1992 has also been amended to ensure that the deemed additional degrouping charge consideration does not affect the 'no consideration' condition in s139(1)(c) TCGA 1992.)

In the context of a s139 'reconstruction' transfer, HMRC have now confirmed that the degrouping charge is eliminated as part of the deemed 'no-gain/no loss' consideration rule. However, HMRC's view is that the degrouping gain is *not* added to the deemed 'no gain/no loss' consideration which forms the base cost for the transferee company.

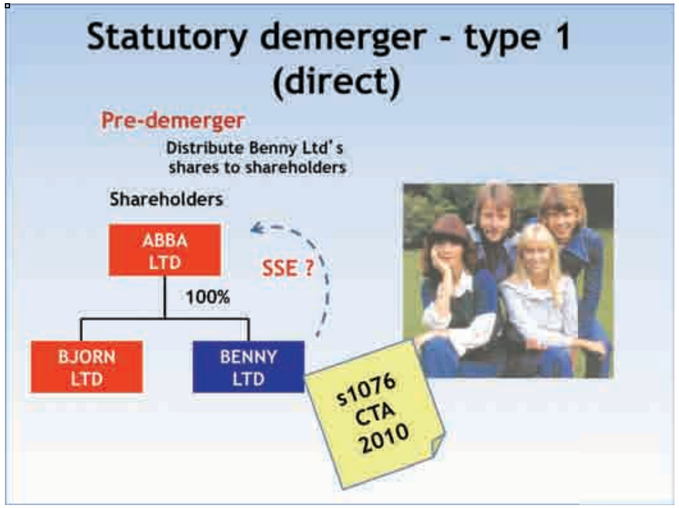
It is important to appreciate that the beneficial FA 2011 treatment of degrouping gains does NOT apply to goodwill or other intangibles created or acquired after 31 March 2002. This is because the corresponding intangibles degrouping charge in s780 CTA 2009 was not amended by the FA 2011. Thus, the normal intangibles degrouping charging rules will continue to apply to such assets.



2.10 Background to statutory demergers

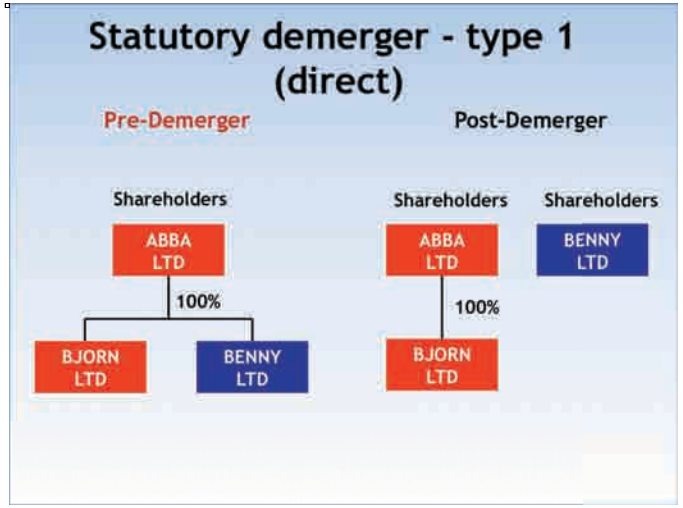
Three types of demerger are permitted by the tax legislation. Each one takes the form of a distribution in specie of one of more trades or shares in one or more 75 per cent trading subsidiaries.

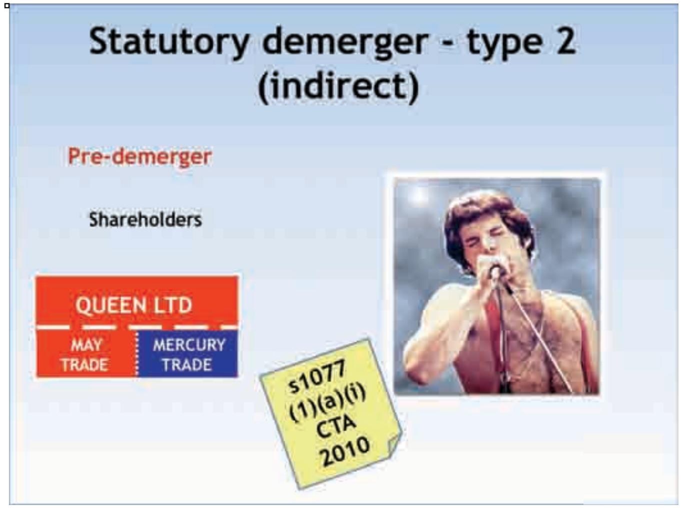
The key advantage of a statutory demerger is that it achieves an 'exempt distribution' for the recipient shareholder(s) without the need to liquidate the distributing company (s1075 CTA 2010 (previously s213(2)(3) ICTA 1988).



2.11 Permitted types of statutory demerger

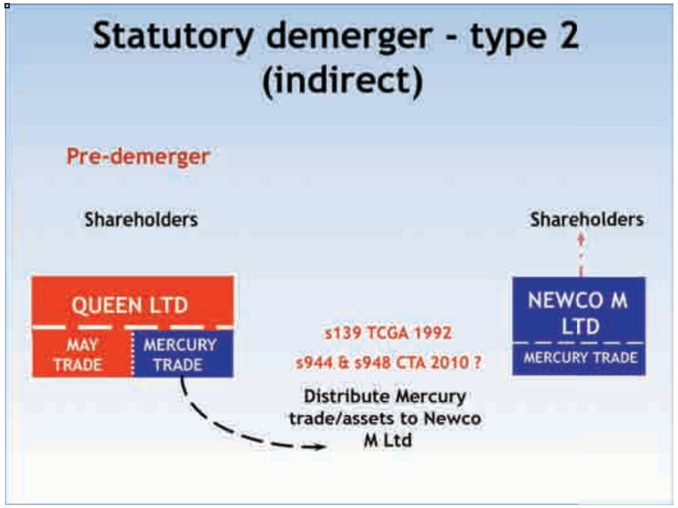
Type I - The distribution by a company to all or any of its members of shares in a 75% subsidiary (or subsidiaries) – often described as a 'direct demerger' (s1076 CTA 2010).

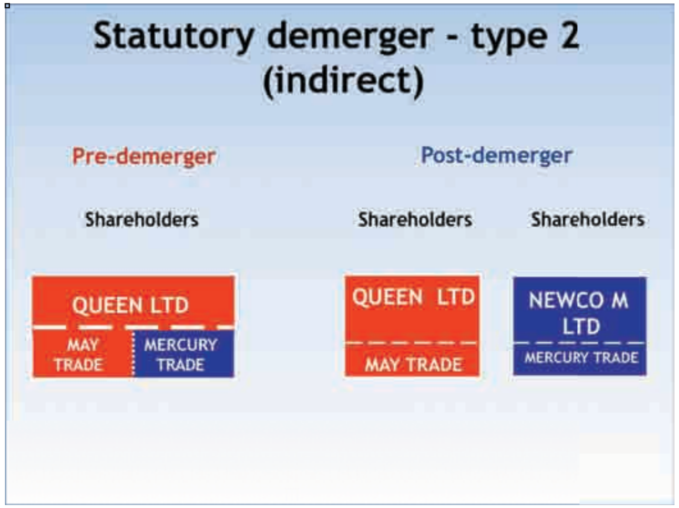




2.12 Permitted types of statutory demerger

Type 2 - The transfer of a company's trade or trades to one or more 'transferee' companies in consideration for the issue of shares in those companies to all or any of the members of the distributing company (this is an 'indirect demerger') (s1077(1)(a)(i) CTA 2010).


Statutory demerger - type 2 (indirect)
Pre-demerger
Shareholders
Shareholders
QUEEN LTD
MAY TRADE
MERCURY TRADE
NEWCO M LTD
MERCURY TRADE
s139 TCGA 1992
s944 & s948 CTA 2010 ?
Distribute Mercury trade/assets to Newco M Ltd


Statutory demerger - type 2 (indirect)
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Post-demerger
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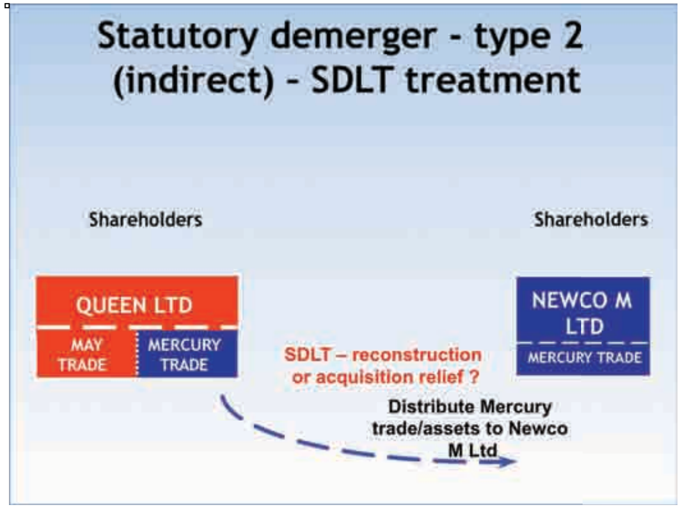
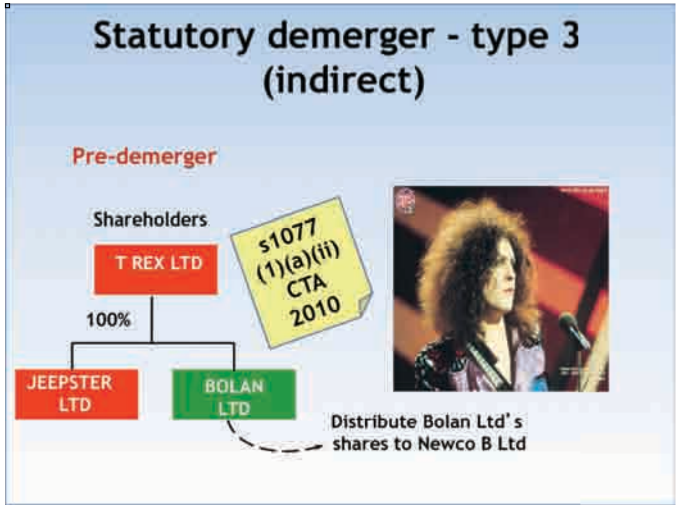
MERCURY TRADE

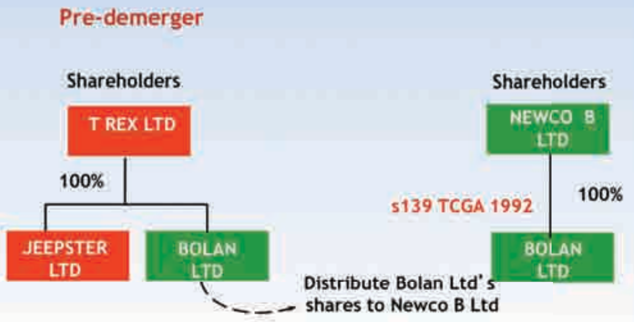




2.13 Permitted types of statutory demerger

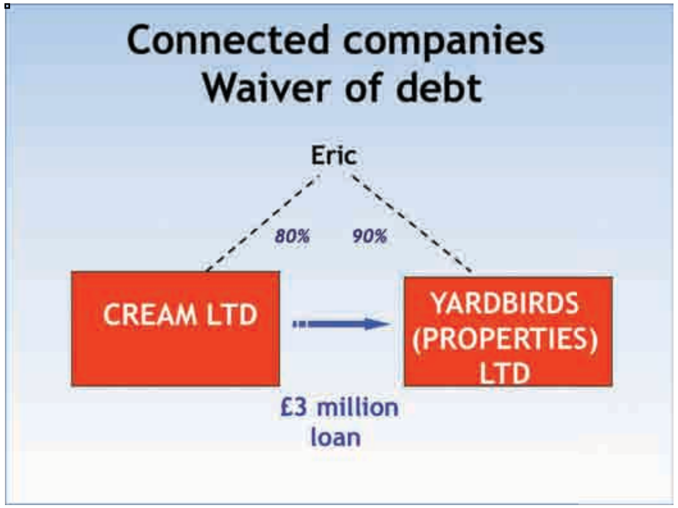
Type 3 **-** The transfer of shares in a 75% subsidiary (or subsidiaries) to one or more 'transferee' companies in consideration for the issue of shares in the companies to all or any of the members of the distributing company (this is an 'indirect demerger') (s1077(1)(a)(ii) CTA 2010).

Statutory demerger - type 3 (indirect)



Choosing the optimum reconstruction route

	Statutory	Non-statutory
Avoid liquidation?	X	√
Investment business?	X	√
Intention to sell demerged business/co?	X	√?
Insufficient reserves	X	√
Degrouping protection		
- Capital gains	√	√ (FA 2011 = SSE)
- Intangibles	√	X



3.1 Example - Waiver of 'connected company' loan

Cream Ltd and Yardbirds (Properties) Ltd ('Yardbirds') are both controlled by Eric.

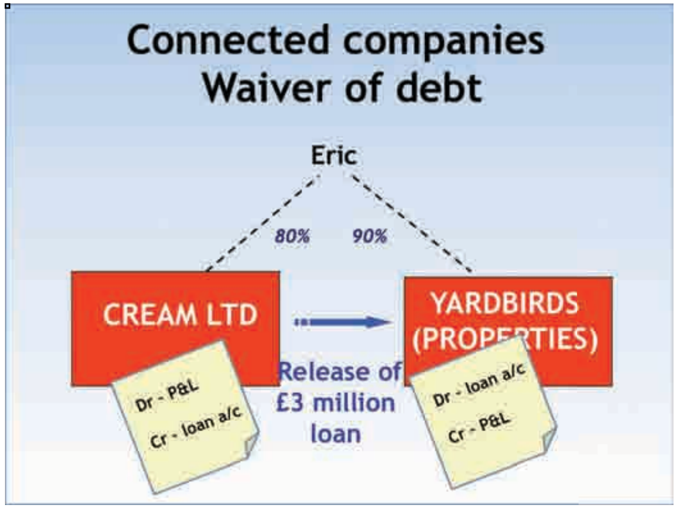
Over the years, Cream Ltd has lent some £3 million to Yardbirds. The loan monies have been used by Yardbirds to purchase various investment properties. Eric would like to arrange for Cream Ltd to waive the debt due from Yardbirds.

The accounting effect of this would be to create:

- A £3 million write-off of the debt in Cream Ltd's P&L
- A credit in Yardbirds' P&L in respect of the £3 million loan released or 'forgiven'.

The loan is clearly a loan relationship (LR), since it relates to the lending of money. In broad terms, the LR tax treatment of debits and credit is based on the amounts reflected in the accounts, but there are important departures from this general rule, which apply in this case.

Section 348 CTA 2010 contains one of the most important exceptions to the normal LR rules where loans are made between 'connected companies' (as defined in s466 CTA 2010).



3.2 LR connection test

The 'connected companies' definition for LR purposes says at sub-section 2,

"There is a connection between a company ("A") and another company ("B") for an accounting period if there is a time in the period when—
(a) A controls B,
(b) B controls A, or
(c) A and B are both controlled by the same person."

Based on the facts in this case, Cream Ltd and Yardbirds would be connected companies for LR purposes by virtue of subsection 2(c) above - Eric controls both companies.

3.3 Tax treatment of connected company debt waiver

The £3 million loan falls within the special LR connected companies rules.

Where a company lends money under a connected companies LR, s354 CTA 2009 provides that the 'release debit' for the write off in its P&L account is ***not deductible*** for corporation tax purposes (unless there is an eligible 'debt/equity' swap or an insolvent creditor situation, which is not the case here).

On the other hand, there is a 'symmetrical' rule in s358 CTA 2009 which effectively provides that credits to P&L account in respect of a 'connected companies' LRs are ***not taxable***.

Releasing inter-company debt

Inter-company account

Dr		£000			Cr £000
10/6/12	Cash repaid	1,000	31/12/11	Management charges	150
			3/6/12	Bank (cash advance)	1,400
30/6/13	Balance c/fwd	700	31/12/12	Management charges	150
		1,700			1,700
			1/7/13	Balance b/fwd	700

3.4 FA 2009 extension for trade debts

Section 42 FA 2009 extended the LR treatment to the 'release of *trade debts' which used to be taxable under s94 ICTA 1988 (now s94 CTA* 2009).

Before this, the tax legislation contained an anomaly (for connected party) trade debts in that they fell within the LR rules for the treatment of the release debit but *not for the credit arising on* the release in the borrowing company which remained taxable under s94 CTA 2009.

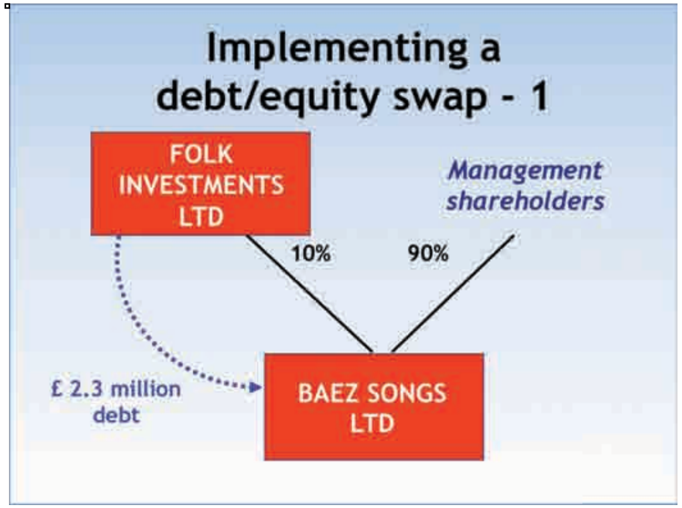
However, since 22 April 2009, the credit generated on the release of a trade debt is also subject to the LR rules, and hence a 'connected companies' trade debt is no longer taxed on its release.

Distressed Debt

	Before	Swap	After
	£'000	£'000	£000
Net Assets	100		100
Share capital	20	480	500
Reserves	(400)		(400)
Shareholders funds	(380)		100
Debt	480	(480)	0
	100		100

Distressed Debt (with P&L release)

	Before	Swap	After
	£'000	£'000	£000
Net Assets	100		100
Share capital	20	80	100
Reserves	(400)	400	-
Shareholders funds	(380)		100
Debt	480	(480)	0
	100		100



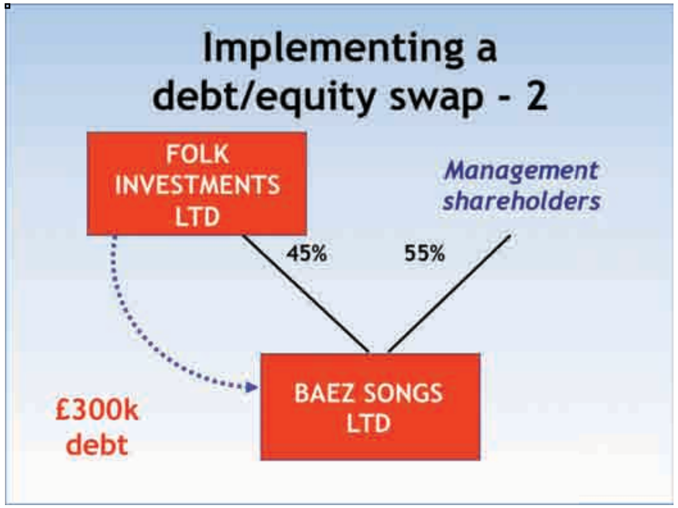
3.5 Example – Debt for equity swap

In recent years, Folk Investments Ltd (FIL) has financed Baez Songs Ltd (BS) with interest-bearing loans of £2.3. BS accounts for these on an amortised cost basis.

Over the last two years or so, BS has experienced a substantial decline in its revenues. This fall in revenue, together with the substantial interest payments on the FIL loan, has generated sizeable trading losses.

BS's directors have approved with FIL their plans to re-brand the business which they hope will enable it to return to profit in the medium term.

As part of this strategy, FIL has agreed to cancel £2 million of its £2.3 million interest-bearing loan in return for new ordinary shares in BS, which would then give it a 45% stake in the company.



Implementing a debt/equity swap - 3

	Dr	Cr
	£	£
Folk Investments Ltd - loan account	2,000,000	
Ordinary share capital		20,000
Share premium		1,980,000
	2,000,000	2,000,000

3.6 Example – Accounting and tax treatment of debt/equity swap

Under GAAP, most companies will debit the loan account with the full amount of the debt waived.
The nominal value of the shares issued in exchange for the 'release' of the debt will be credited to share capital, with the balance being credited to share premium account.
In distressed debt scenarios, it is likely that the loan will exceed the fair value of the shares being issued in exchange. Hence the share premium account will contain an element of 'waiver' – however, such amounts are exempt under the LR rules.

4.1 Section 455 CTA 2010 charge on loans to participator

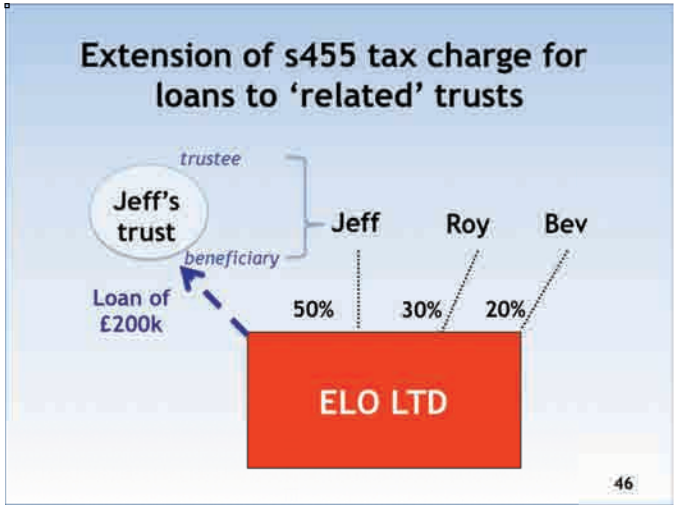
Many owner managers will have overdrawn loan accounts, representing amounts ‘drawn’ by them or ‘personal expenses’ that have been charged to them. Common items that should be charged to the directors’ loan account include ‘personal’ credit card payments, personal expenses paid by company, and personal entertaining.

HMRC insist that the company’s record keeping should ensure that balances of directors loan accounts are accurate and kept up to date

A s455 CTA 2010 tax charge arises where a close company makes a loan or advances money to an *individual* participator (normally a shareholder) OR an associate of a participator – UNLESS the loan/advance is made in the ordinary course of a lending trade (very rare!). The charge only arises if the company is close when the loan/advance is made.

The s455 tax charge strictly arises on overdrawn loans at the year-end date but provided the overdrawn amount is cleared (by repayment or release) within nine months of the year-end, no s455 tax is payable (under the s458 CTA 2010 ‘discharge’ rules).

Overdrawn loan accounts may also be subject to a beneficial loan charge if they become overdrawn at any time in the tax year.



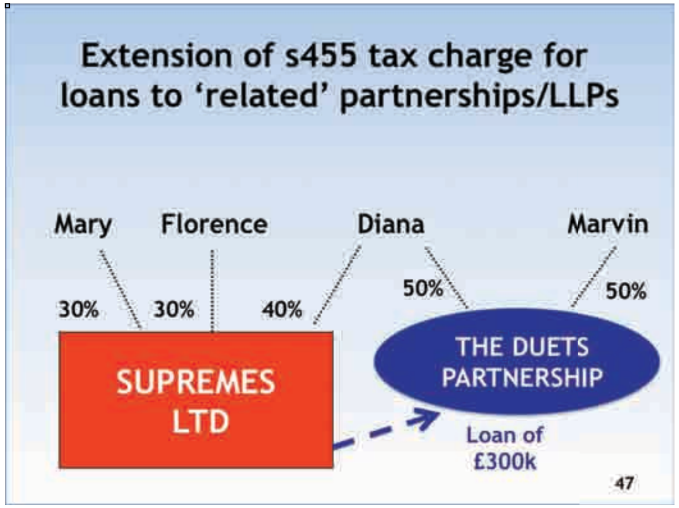
4.2 Extension of s455 charge on loans to ‘related’ trusts or partnerships/LLPs

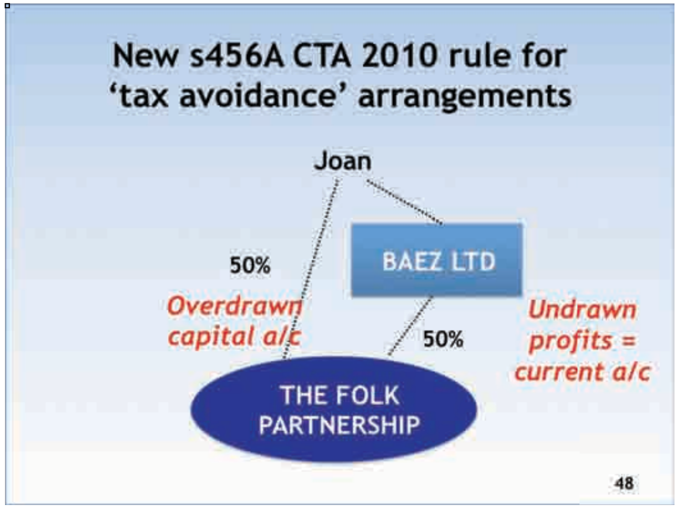
The Finance Bill 2013 has widened the scope of the s455 charge which (from 20 March 2013) will now also apply where a close company makes a loan or advance to:

- the trustees of a settlement in which at least one of the trustees or beneficiaries (actual or potential) is a participator (or an associate of a participator); or
- a partnership or LLP that includes at least one partner/member who is also a participator (or an associate of a participator). The company itself need not necessarily be a partner for the charge to apply.

One of the key issues is whether amounts invested into the partnership or LLP on capital account should be caught by these rules.

Prior to 20 March 2013, HMRC’s manuals took the view that loans made by close companies to (English) partnerships (which included at least one partner who was a shareholder of the company) were already caught by s455 CTA 2010. This makes it clear that the s455 charge will now apply to all partnerships (including LLPs and Scottish partnerships).





4.3 New anti-avoidance rule for close companies

A new s456A CTA 2010 introduces a targeted anti-avoidance rule for close companies . This rule imposes a 25% tax charge on the relevant company (which would otherwise escape the 'normal' s455 tax charge or a normal income tax charge) where:

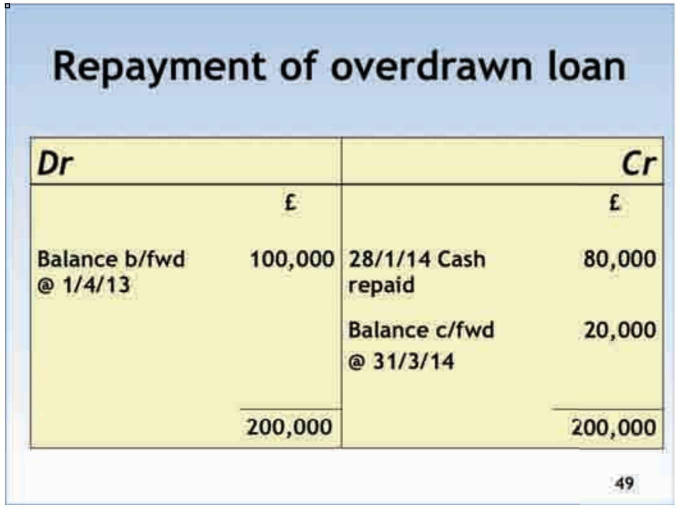
- it is a party to tax avoidance arrangements (which are widely defined); and
- as a result of those arrangements, a 'benefit' is directly or indirectly conferred on a participator of the company (or their associate).

It seems that HMRC consider that this charge might be invoked in certain 'hybrid' partnerships where

-an *individual* partner's capital account becomes overdrawn (after 19 March 2013);and

-the overdrawn account has effectively been financed by the undrawn profits (or capital introduced) of a corporate partner.

Under the 'benefit' rules, the company could be liable to a s446A CTA 2010 charge on the individual partner's overdrawn loan account (or, if lower, the amount funded by the corporate member).



Repayment of overdrawn loan

Dr			Cr
	£		£
Balance b/fwd @ 1/4/13	100,000	28/1/14 Cash repaid	80,000
		Balance c/fwd @ 31/3/14	20,000
	200,000		200,000

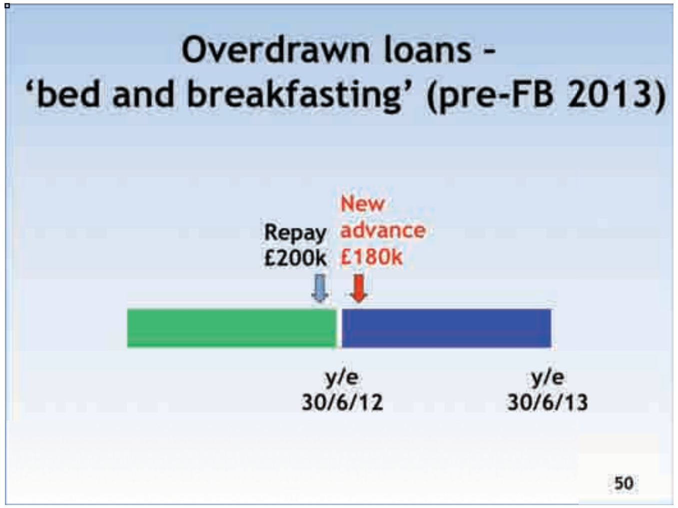
49

4.4 Section 458 relief from s455 tax

If a shareholder-director’s loan account is cleared by repayment (this could be the payment of a dividend/bonus), the company is entitled to relief from or repayment of the s455 tax (or corresponding part of it).

Section 458 CTA 2010 discharges the company from any s455 tax liability where the loan is repaid within nine months of the year-end.

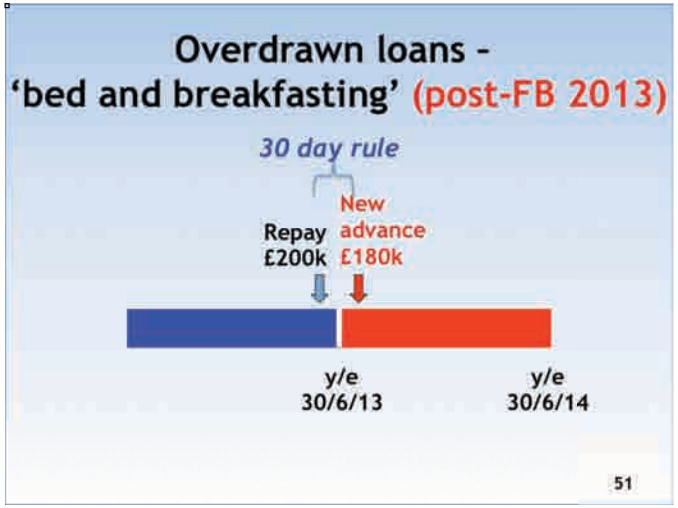
However, if the loan is not repaid until a later date, the company must make a claim to reclaim its s455 tax (within four years of the end of the *financial year* in which the loan is repaid). HMRC are then required to repay the s455 tax within nine months of the end of the corporation tax accounting period (CTAP) in which the loan is repaid.



4.5 Bed and breakfasting of overdrawn loans

HMRC have always disliked cases where an overdrawn loan account has been temporarily repaid before the s455 tax charge is triggered with a similar amount being withdrawn again in the next accounting period, so that the loan account becomes overdrawn again (see HMRC Enquiry Manual - EM8565).

In the past HMRC have enquired into the facts and have sought to challenge these so-called ‘bed and breakfasting’ arrangements on the grounds that they are a sham, with penalties being sought on the basis that there is a careless or deliberately incorrect claim for s458 CTA 2010 ‘discharge’ relief.



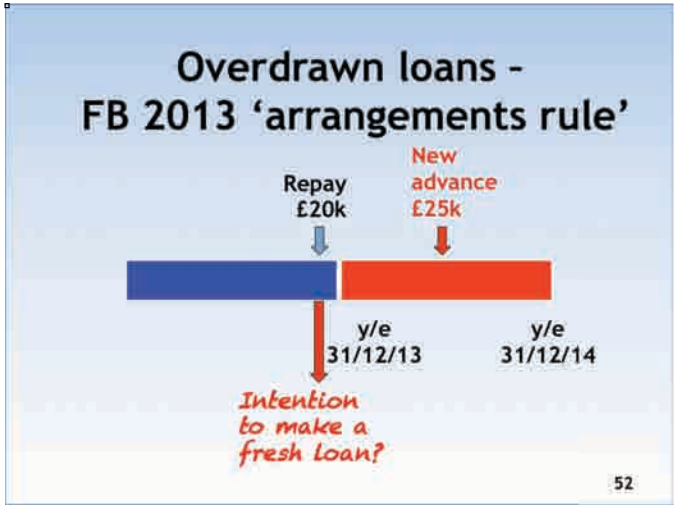
4.6 Finance Bill 2013 and 'bed and breakfasting' cases

The Finance Bill 2013 now denies s458 'repayment' relief being given for s455 loans in either of the following two cases:

A. The 30 day repayment restriction

Within a 30 day period, there are one or more repayments of a s455 loan total £5,000 or more and fresh loans/advances are made to the same individual (or their associate).

It does not matter whether the repayment precedes the new loan or vice versa – the only requirement being that both have to occur within a 30 day period.

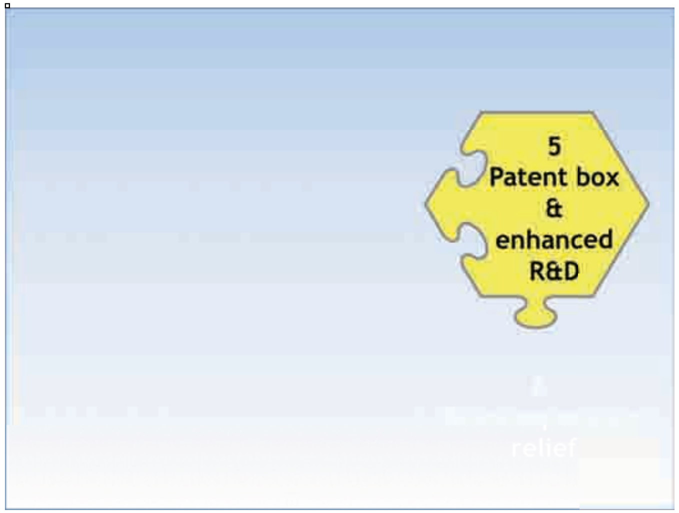


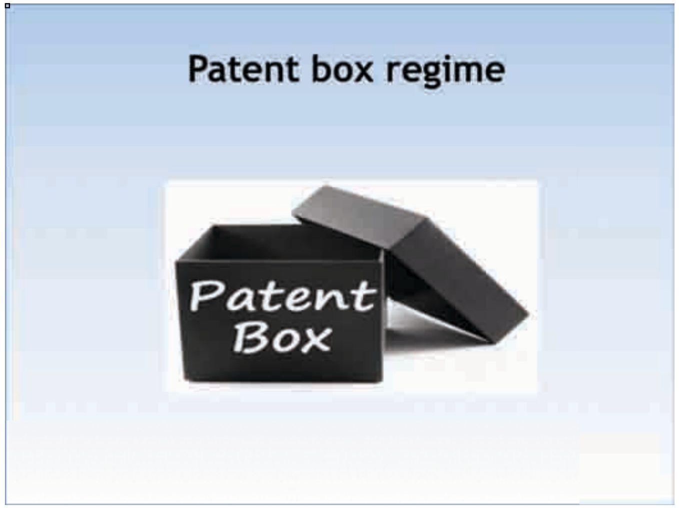
4.6 Finance Bill 2013 and 'bed and breakfasting' cases (cont'd)

B The 'intention or arrangements' rule

This rule applies where a shareholder's s455 loan is £15,000 or more, and at any time after a repayment is made the company makes a fresh loan or advance to the same individual (or their associate) AND AT THE TIME OF THE REPAYMENT, there is an intention (by anyone) to make the fresh loan/advance or arrangements have been made to make a fresh loan/advance. This effectively imposes a 'motive' test at the time of the repayment.

In such cases, s458 repayment relief will be denied.





5.1 Introduction to patent box

The patent box commenced on 1 April 2013 and, by election, enables a qualifying company to claim a reduced corporation tax rate on its patent income. The corporation tax reductions are being phased in over a four-year period . The full benefit of the relief – a 10% corporate tax rate on patent income - will apply from 1 April 2017.

The election under s357A CTA 2010 enables the company to claim a CT deduction broadly equal to:

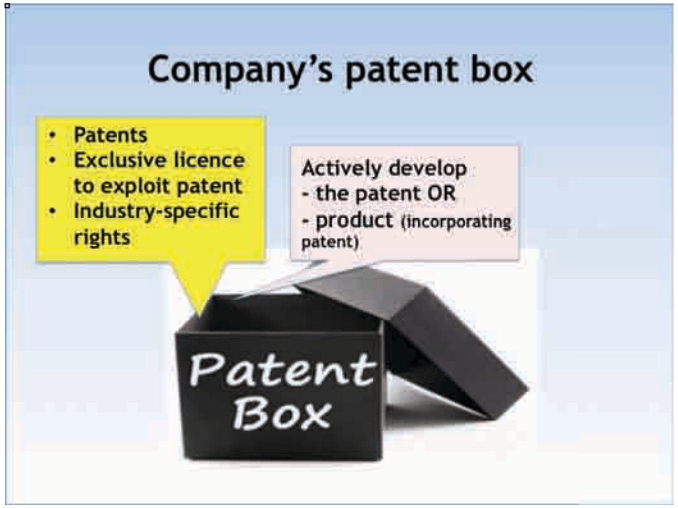
Relevant IP profits of the trade x (MR – IPR (10%)/MR)

Where MR = Main rate of corporation tax
IPR = Special IP rate)10%)

The patent box regime focuses on patents because they have a strong link with the research and development (R&D)/high-tech sector. The relief provides an incentive for UK companies to develop innovative-patented products, and hence should encourage the valuable technicians and workers associated with their development and exploitation in the UK.

In many cases, for the smaller company, deciding whether to enter the patent box is likely to require liaison with IP/patent lawyers.

The patent box legislation is lengthy (over 40 pages) and complex.



5.2 Conditions for profits to get into the patent box

Only companies within the charge to UK corporation tax can qualify for the patent box. The patent box regime broadly requires:

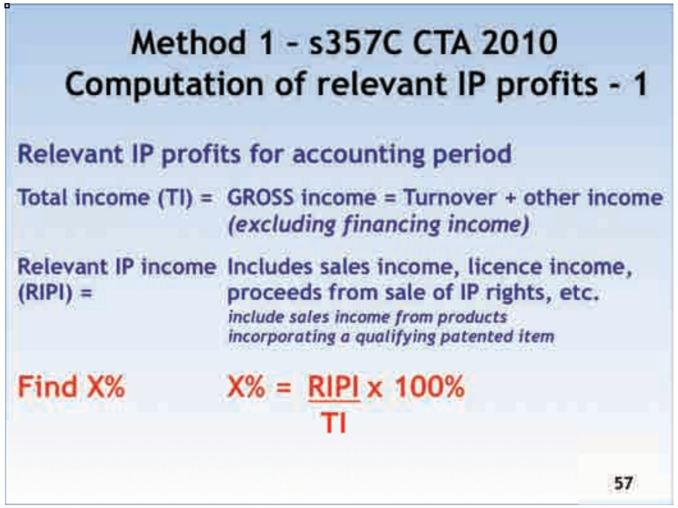
- A qualifying company within s357B CTA 2010 i.e. one which owns one or more patents or has an exclusive right over them;
- An election to be made for the reduced rate of corporation tax.

Broadly, the rules require exclusivity in a national territory or a specific commercial field. The company must actively have actively developed the patent or a product incorporating the patent.

If the company is a member of a group (which is very widely defined – see s357GD CTA 2010), it must also meet the 'active ownership' condition for the CTAP in s357B(5) CTA 2010. This requires the company to perform a significant amount of management activity in relation to its IP rights. The policy aim is to prevent passive IP holding companies taking advantage of the patent box rate.

For the purposes of the patent box, the patent must be granted with the UK patent office, the European patent office, or the relevant patent offices of certain other countries. It is sufficient for the patent to be granted by one of the 'permitted' offices, although special advice is often required since commercial factors may require patents to be filed in several countries.

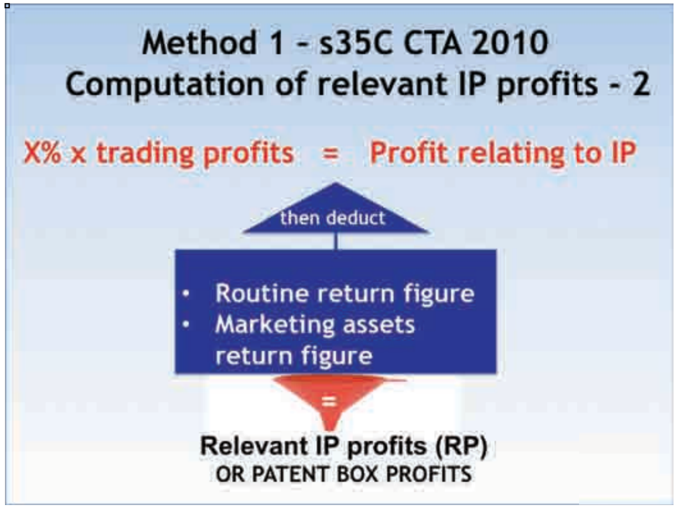
The patent box only applies from the date the patent is granted but an election can be made for the patent pending period.



5.3 Outline - computing patent box profits

There are two methods of calculating the patent box profits.

- The s357C CTA 2010 formula method – which broadly calculates the relevant IP profits of a trade (as shown in slides 51 and 52);
- The 'streaming' method (under s357DA CTA 2010), under which companies can calculate their IP profits by comparing their gross IP income with the actual IP costs on a 'just and reasonable' basis. This method is likely to be beneficial if the company's patent income is significantly more profitable than its other income streams (since the formula method would give a higher allocation of costs to its patent income).



5.4 S357C CTA 2010 formula method

The formula method is uses the company's total income and relevant IP income as the basis for splitting its adjusted trading profits *(step 3 in s357C CTA 2010)*.

Two specific deductions are then required against the taxable profit relating to IP.

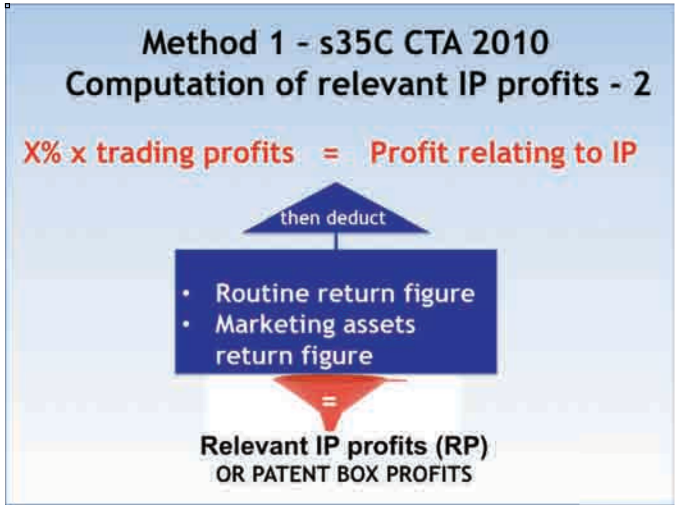
Routine return figure – This assumes that, in the absence of any patents, companies are able to make a10% mark-up on all their 'routine deductions' (see s357CI to s357CK), being the aggregate of capital allowances, premises costs, personnel costs, plant and machinery costs, legal and professional costs, and utilities/computing etc.

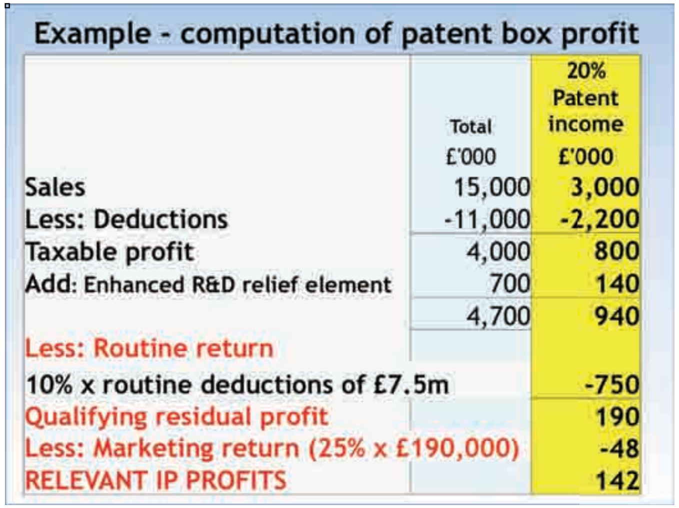
Note that salaries included in an enhanced R&D claim and any loan relationship items are excluded from the 'routine deductions' figure. The routine return figure is calculated as:

Total of routine deductions x 0.1 x X% (see slide 51)

The 10% mark-up is deducted stripped from the patent box profit to arrive at the qualifying residual profit.

Marketing assets return figure -





Example - computation of patent box profit

	Total £'000	20% Patent income £'000
Sales	15,000	3,000
Less: Deductions	-11,000	-2,200
Taxable profit	4,000	800
Add: Enhanced R&D relief element	700	140
	4,700	940
Less: Routine return		
10% x routine deductions of £7.5m		-750
Qualifying residual profit		190
Less: Marketing return (25% x £190,000)		-48
RELEVANT IP PROFITS		142

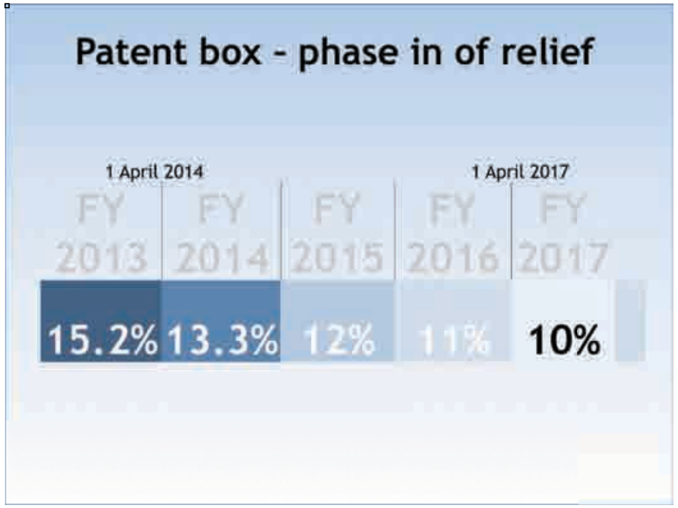
5.4 S357C CTA 2010 formula method (cont'd)

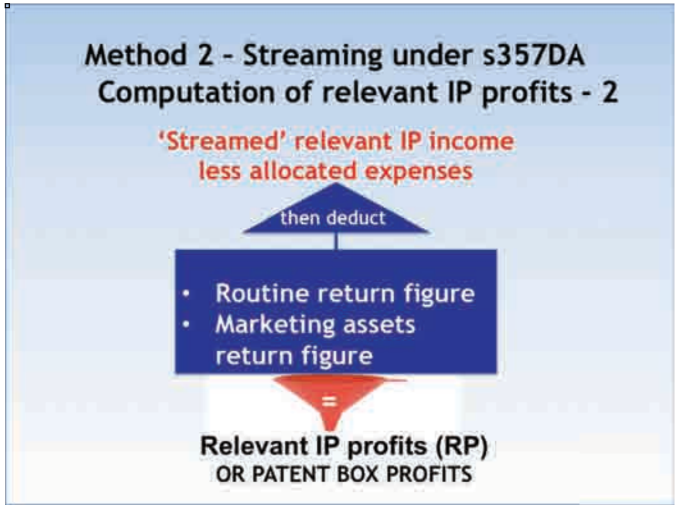
Marketing assets return figure - If a company cannot elect for 'small claims treatment (or considers its brand value to be less than 25% of the profits), it must calculate a 'notional marketing royalty'. This is based on what the company would have to pay a third party to exploit the brand, based on OECD transfer pricing principles.

The marketing assets return is deducted to arrive at the relevant IP profit which will benefit from the reduced 'patent box' rate.

5.5 Patent box losses

Patent box losses can only be carried forward against future patent box profits. In a group context, excess patent box losses must be surrendered to other patent box companies making profits.


Patent box - phase in of relief
1 April 2014
1 April 2017
FY 2013
FY 2014
FY 2015
FY 2016
FY 2017
15.2%
13.3%
12%
11%
10%


Method 2 - Streaming under s357DA
Computation of relevant IP profits - 2
'Streamed' relevant IP income
less allocated expenses
then deduct
• Routine return figure
• Marketing assets return figure
=
Relevant IP profits (RP)
OR PATENT BOX PROFITS

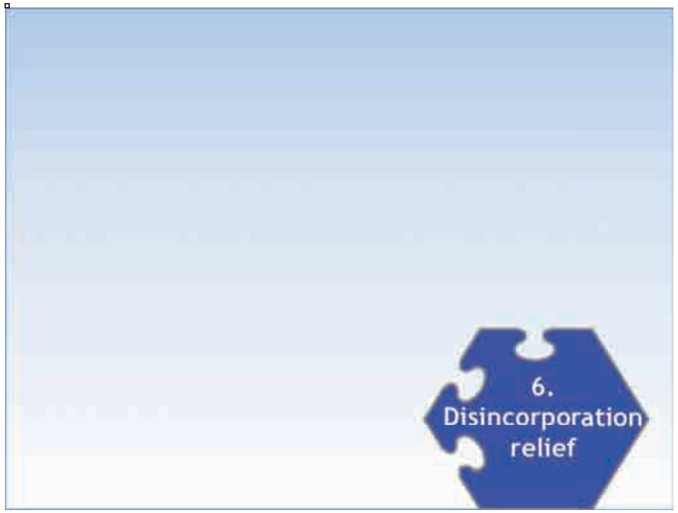
5.6 Enhanced R&D relief for SMEs

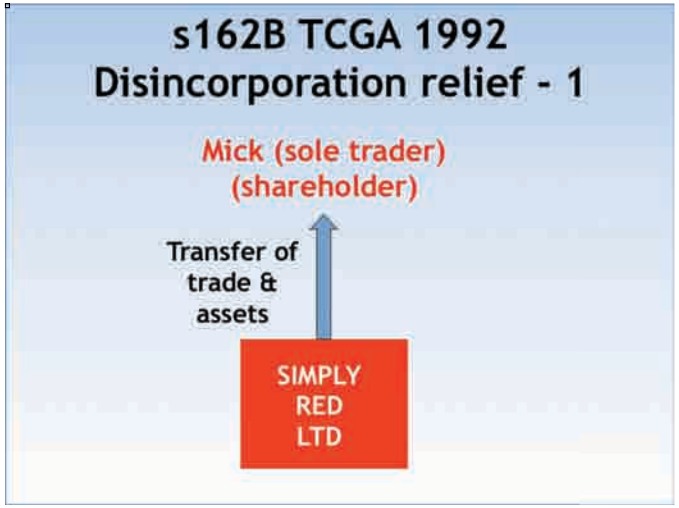
SMEs can claim enhanced research and development (R&D) relief for their R&D activities. (For these purposes, an SME is broadly a company with fewer than 500 employees *and* either has an annual turnover not exceeding €100 million or a balance sheet total (gross assets) not exceeding €86 million. A SME cannot be a member of a large group).

SMEs are able to claim an enhanced R&D deduction of 125% of their qualifying R&D expenditure (including relevant R&D staff costs and related employers' NIC and consumable items etc.).

This means a total deduction of 225% of the qualifying R&D spend. With a 23% CT rate, enhanced R&D relief provides a 54p tax saving for every £1 of qualifying R&D spend (45p in the £1 for companies paying the small profits rate of 20p).

Loss-making companies can claim a repayable R&D tax credit, equal to 25% of the eligible R&D expenditure.



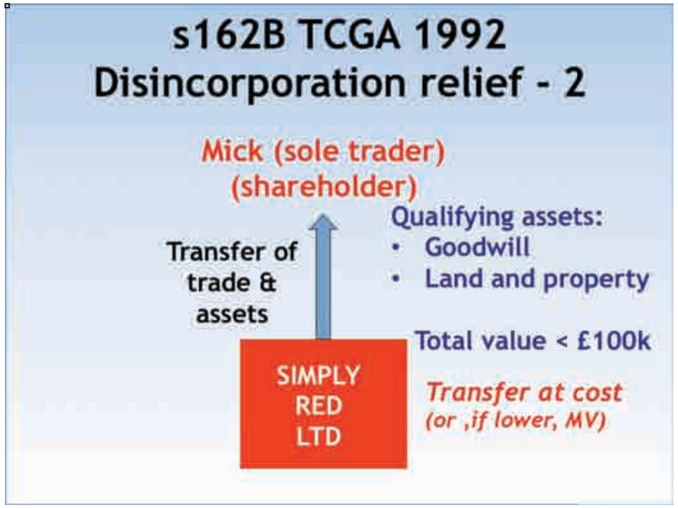


6.1 Disincorporation relief – background

A special tax 'deferral' relief is now available for smaller companies to ease the tax burden on 'disincorporation'. Following the OTS's recommendations in 2012, the Government accepted the need for a special relief to assist those 'small' companies who would now prefer to 'switch' to sole trader or partnership status for commercial and tax reasons. The disincorporation relief (in s162B and s162C TCGA 1992) will only last for a 'five year' period (from 1 April 2013 until 31 March 2018) and excludes transfers to LLPs.

The relief is perhaps not as generous as proposed by the OTS since it only deals with the corporation tax on the capital gains/intangibles profits that would otherwise arise on the transfer of goodwill and property. The assets will normally be distributed to the shareholders, but the disincorporation relief does not extend to the shareholders' distribution tax charges.

When a company distributes chargeable assets (such as goodwill and property) to its shareholders, this normally gives rise to a capital gain in the company, based on market value. Similarly, intangibles' profits would arise where post-31 March 2002 is transferred.

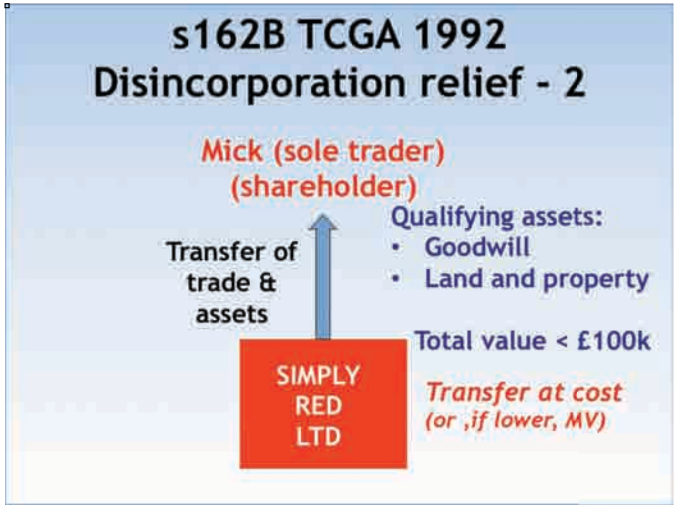


6.2 Conditions for disincorporation relief

Section 162B TCGA 1992 provides that the company and the recipient shareholder(s) can make a joint claim for disincorporation relief where a company transfers its business to some or all of its shareholders provided it is a 'qualifying business transfer'. The claim must be made within two years of the transfer date.

For these purposes, a qualifying business transfer is one that satisfies all the following conditions:

- the business is transferred as a going concern;
- the business is transferred with all its assets (or all of them other than cash);
- the aggregate market value of the qualifying assets transferred (broadly, goodwill and 'chargeable' land and property assets) does not exceed £100,000;
- all the shareholders to whom the business is transferred are individuals; and
- each of the shareholders has held their shares for at least 12 months prior to the business transfer date.



6.3 Section162B TCGA 1992 claim for disincorporation relief

Provided a s162B TCGA 1992 claim is made, land and property and pre-1 April 2002 goodwill is deemed to be transferred at the lower of:

- the original cost of the asset; and

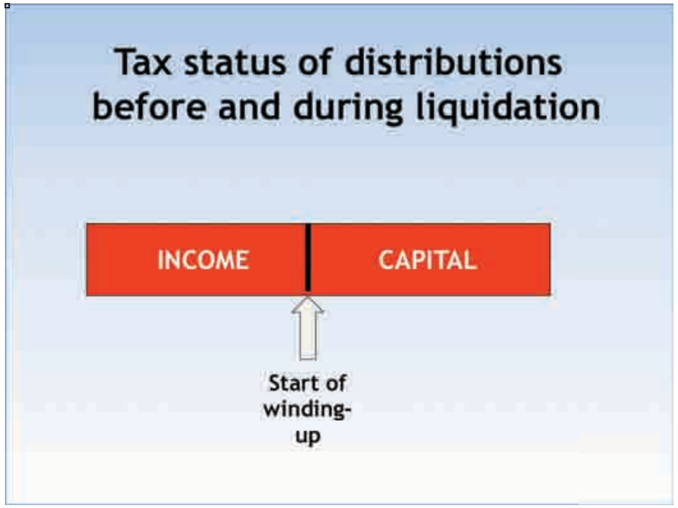
- the market value of the asset.

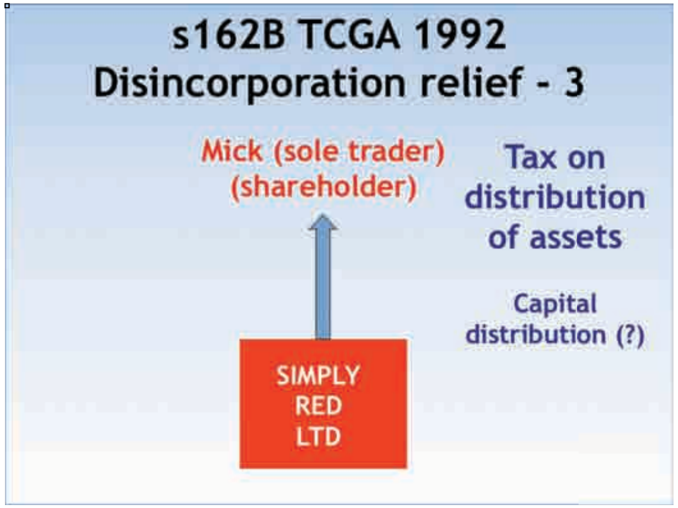
If the transfer relates to post-31 March 2002 goodwill, s849A CTA 2009 treats it as being transferred at the lower of its tax written down value (i.e. cost less amortisation) or market value. However, if the goodwill is not carried in the company's balance sheet, the deemed transfer value is deemed to be 'nil'.

In the rare cases where purchased goodwill has not been amortised, the lower of original cost or market value is taken instead.

3.4 Transfer of other assets

Because the company and the shareholders will generally be 'connected', they can jointly elect to:
- transfer trading stock at the higher of cost or transfer price (s168 CTA 2009) to displace the deemed market value rule in s166 CTA 2009; and
- transfer plant and machinery at its tax written down value (under s266 CAA 2001).





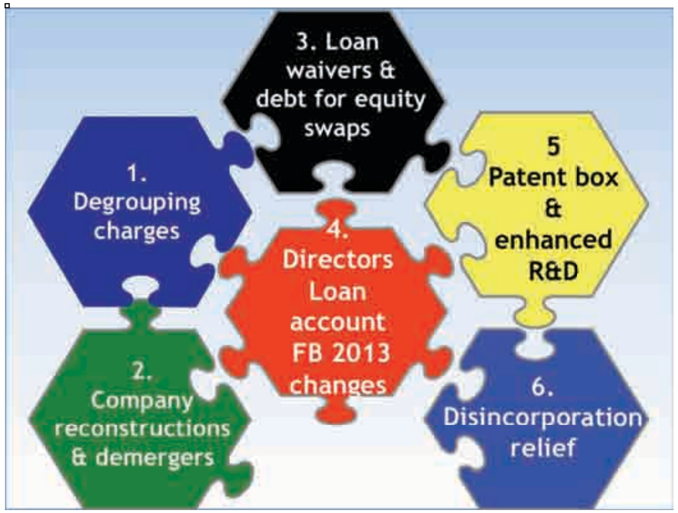
6.5 Tax charge on assets distributed to shareholders

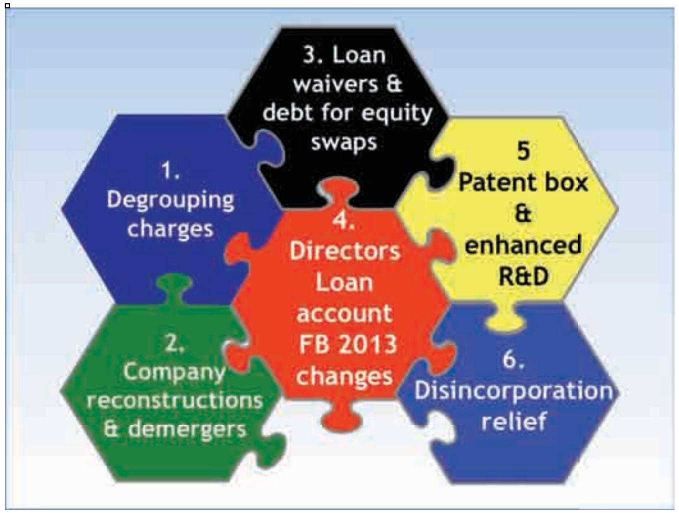
In the vast majority of cases, the shareholder(s) will generally procure an in-specie distribution of assets by the company to them. However, it is important to appreciate that there is no disincorporation relief for the normal tax charges that arise when assets are distributed to the shareholders (for no consideration).

Following the abolition of the 'generous' ESC C16, companies wishing to 'disincorporate' will often seek to distribute the assets to the shareholders during a formal members winding-up, since the value of the assets would be treated as a capital distribution. In most cases, this would enable the recipient shareholder(s) to enjoy the beneficial 10% CGT entrepreneurs' relief rate on their capital distributions.

The preferred route of 'striking off' the company under the Companies Act 2006 process is unlikely to be tax efficient in many cases. This is because the statutory replacement to ESC C16 - s1030A CTA 2010 – only enables distributions of up to £25,000 (only) made during the course of a dissolution to be treated as capital gains tax receipts (as opposed to income distributions). However, this treatment is only available provided the company has secured or will secure the payment of all its debts.

If a company distributes more than £25,000, then the entire amount will be treated as an income distribution. Hence, in the vast majority of cases, a disincorporation will need to be implemented via a formal members' liquidation.




3. Loan waivers & debt for equity swaps
1. Degrouping charges
5 Patent box & enhanced R&D
4. Directors Loan account FB 2013 changes
2. Company reconstructions & demergers
6. Disincorporation relief