Welcome to the February 2017 edition of Invest Assure News, a regular newsletter from PKF Littlejohn's Invest Assure team, providing a round-up of the main developments in accounting and general market matters.

Changes to the Corporation Tax system – how are you affected?

From 1 April 2017, three significant changes to the Corporation Tax system have the ability to affect groups, including most investment funds and VCTs, operating in the UK in some form. Whether these changes are positive or negative for a group will depend on their specific circumstances. Chris Riley, head of PKF Littlejohn's tax team, examines the potential impact.

Corporate loss relief changes

For many years, the fundamentals of how relief for corporate losses could be obtained were fundamentally unchanged. Losses arising on a specific income line could be (with limitations) used in the same matching period against other profitable income sources, or surrendered to group or consortium members. Any excess could be carried forward indefinitely, but only used against the same income line in future years, and only in the same company.

The first fundamental change to this rule arose out of the banking crisis. For banks, relief in future years from brought forward losses was restricted to 50% of profits arising in the later period. This measure did not deny outright the relief for the losses arising, but extended the time period over which that relief could be applied.

It was arguably only a matter of time before this rule was extended to corporates in general. From 1 April 2017, corporate groups (defined by the Corporate Tax legislation and not the IFRS 10 definition, as originally proposed), will only be able to cover 50% of their profits in aggregate by way of brought forward losses. However, this is subject to a £5 million profit allowance per group before that limitation takes effect, with the 50% restriction only arising on profits above that amount.

Alongside this measure, there is far greater flexibility of how losses can be used upon carry forward. Carry forward losses that arise after 1 April 2017 can now be used within a company against different income sources to those which initially generated the loss, and can be surrendered within groups or consortia on a non-matching period basis.

There will be winners and losers from these changes. The much greater flexibility for using losses 'out of period' should significantly prevent the risk of 'trapped losses' which will benefit many, and reduce the potential tax inefficiency risks arising from UK group structures. However, Investment groups with average profits in excess of £5m may suffer delays in utilising historic losses already incurred, or significant 'one-off' losses that arise in the future. Deferred tax asset calculations for these groups may become more involved in considering how, and when, such losses can reasonably be utilised.

For groups with significant capital allowance claim potential, it is worth remembering that companies have a choice as to whether to claim capital allowances or not in a given period. Claiming allowances early to crystallise losses may now be disadvantageous or beneficial, depending on the profit or loss profile of the group now and in the future. A detailed review should be undertaken on an annual basis to determine the best capital allowance and loss crystalisation strategy for the group.

This review is particularly important for companies that will (without action) carry losses over past the 31 March 2017. These losses are not subject to the same flexibility and retain the same income source/company limitations. Where they may be scope to surrender future losses, these companies may be advised to disclaim capital allowances in earlier return periods that can still be amended, so as to enhance the future surrenderable loss potential for the group.

The Interest Cap

The rules governing the tax deductibility of interest paid by companies have seen considerable variation in recent years. Transfer pricing was introduced between UK corporates in 2004, which affected debt funding on a wider basis than previously. More recently, in January 2010, the Worldwide Debt Cap was introduced, which aimed to prevent UK corporates from loading with connected party debt (and associated interest costs), often borrowed from low tax jurisdictions.

The Interest Cap changes will repeal the Debt Cap rules, and are being introduced in accordance with the OECD BEPS initiative. Under the new rules, groups will be generally limited to the amount of net interest that they can deduct against profits chargeable to UK Corporation Tax in a given period to a ratio of 30% of tax adjusted EBITDA.

Interest for these purposes includes other interest type payments, including alternative finance returns, derivative payments, but excluding foreign exchange adjustments arising on the principal balance. The balance tested is net interest – so any interest type returns are taken into account to reduce the tested amount.

Because short term fluctuations in EBITDA may affect the capacity to deduct interest, carry forward provisions apply to permit disallowed interest payments to be relieved in future periods when the ratio is not exceeded.

However, two exceptions to this basic rule apply – a group can opt to replace the 30% ratio with the external gearing ratio applicable to the worldwide group, which may be beneficial for UK groups that are highly leveraged for genuinely commercial reasons. However, some restrictions apply to prevent this alternative basis from being abused.

Secondly, as with the loss relief changes, a de minimis level of up to £2 million of net interest expense is automatically allowable under the interest cap rules for UK groups without the need for further testing. However, it should be noted that this does not remove the requirements for large groups to comply with transfer pricing requirements, which will still be relevant in determining whether interest costs incurred from related parties are reasonably priced on an arm's length basis.

Substantial Shareholdings Exemption

Finally, a measure that is, in our experience, likely to be almost wholly good news. Again, the changes take effect from 1 April 2017.

In place since 2002, the Substantial Shareholdings Exemption applies to exempt gains from Corporation Tax where qualifying conditions are met. The main conditions are:

- A 10% or greater shareholding was held in the company disposed of
- The company sold is a trading company
- The investor company was a trading company or member of a trading group before, and immediately following, the disposal
- These conditions persisted for at least 12 months prior to the disposal.

The third condition – the trading company test for the investor company - has proven particularly problematic since the inception of the legislation. In particular, groups that were wholly trading throughout the majority of their existence but entering into a break up phase had significant issues as the final disposals were made in determining trading status. The limitation also discriminated against companies making significant, but not controlling, investments into multiple companies.

For disposals made after 1 April 2017, this condition is removed, giving far greater access to the relief by corporate investors. The exemption applies to losses, as well as gains, so there may be some groups that will now not receive relief for capital losses; however, the limited scope for gains to arise against which to offset these potential losses is likely to reduce the risks arising.

The Substantial Shareholdings Exemption remains imperfect, but giving far greater certainty for investor groups is a step in the right direction.

We hope you've found this issue useful. If anyone within your business would like to receive future issues, please send their details to Ruby Crowley (rcrowley@pkf-littlejohn.com).

Our specialist team is here to help. If you would like advice on any of the issues discussed in this newsletter, please contact one of our Invest Assure team.

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