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CORPORATION TAX LOSS RELIEF - CHANGE OF CLIMATE IN 2017

Corporation tax

Fundamental changes to the UK corporate tax system are due to take effect from 1 April 2017, now just a few months away. These changes are still being consulted upon so the proposals may yet change, but companies should investigate their potential exposure now: no transitional relief is currently envisaged.

Of the three principal changes listed below, two are likely to have an adverse impact upon some taxpayers:

1. Tax losses carried forward will only be able to offset 50% of taxable profits arising after 1 April 2017 (subject to a £5m group de minimis where 100% can be offset)
2. Tax losses which arise after 1 April 2017 can be carried forward and set against profits of both the company and other companies in the group (without streaming, ie they need not be set against profits from the same type of activity)
3. Tax relief for interest payments will, from 1 April 2017, be limited to 30% of taxable EBITDA - subject to a £2m group de minimis - with any excess being carried forward (the 'earnings stripping rule').

This briefing focuses on the first two of these changes but also comments on their interaction with the proposed earnings stripping rule and the late paid interest rules.

Scope

The new rules will apply to most types of losses carried forward, including trading, property income, non-trade debits and management expenses (although capital losses will not be affected).

However they will only apply where the 'group' has taxable profits in excess of £5m per annum. The Consultation document envisages that a 'group' will be defined by reference to economic control (possibly aligned with the IFRS 10 definition) for this purpose.

Private equity backed groups will be concerned to ensure the non-consolidation treatment adopted by the fund General Partner under IFRS 10's investment entity exemption doesn't lead to the aggregation of all the fund's portfolio investments for the purposes of allocating the £5m.

Loss set-off

Group relief loss claims will still be required where it is desired to set a loss against profits in the same year but a surplus loss arising after 1 April 2017, once carried forward, can then be transferred to another group company without streaming. However, streaming will still be required for pre-April 2017 losses carried forward (with separate streams for trading and non-trading losses). Retaining this complexity is a missed opportunity to do away with the 'schedular' system of taxation, although the Consultation document indicates that the Office of Tax Simplification may look at this further.

More positively, losses carried back will not be restricted - so they may be useful for covering the residual 50% of taxable profit.

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The new rules will be accompanied by various TAARs. These are likely to target deliberate fragmentation of groups to abuse the £5m de minimis, prevention of profit shifting to mop up losses carried forward before April 2017 and rules designed to prevent tax arbitrage of profits and losses in M&A transactions.

Key implications

The new loss relief rules, which mirror those introduced by some other countries including Germany, may operate as a form of minimum tax – though the £5m de minimis should ensure that a majority of businesses are not adversely impacted. Lossmaking or highly leveraged businesses can no longer assume that they won't have a cash tax liability.

Groups will need to factor these changes into their tax models to ensure they optimise reliefs and avoid stranding them in the wrong company.

Companies subject to the late paid interest rules (including deeply discounted bonds) may wish to consider whether to crystallise tax relief before 1 April 2017 (with restricted loss carry forward potential) or after 1 April 2017 (potentially caught by the earnings stripping rule).

Losses used against income of a new trade

Finally, it is worth noting the recent case of Leekes Ltd v HMRC. In that case, a buyer acquired a loss making company and hived up its trade, claiming to offset tax losses of the acquired business against the combined profits of the merged trade under the old succession provision in s343 of ICTA 1988.

The original decision in favour of the taxpayer has recently been overturned by the Upper Tribunal in favour of a requirement to stream the target's losses against profits attributable to the target's trade. It remains to be seen whether this decision will be appealed, but the rationale of the decisions to date highlights how differences in the way in which businesses are structured may have material tax implications.

Your next steps

If you have any questions over the efficient use of losses under the proposed new rules or the current rules, please get in touch with your usual BDO adviser or contact our corporate tax experts overleaf.

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