

Corporate capital gains and the Finance Bill

(Lecture B1063 – 22.11 minutes)

Freezing of the indexation allowance

The long-standing indexation allowance which has been available to companies to reduce gains following the disposal of chargeable assets is to be frozen with effect from 1 January 2018 (CI 26 F(No2)B 2018). Accordingly, when a company makes a gain on or after 1 January 2018, the indexation which is applied to that gain will be calculated up to December 2017 – in other words, the allowance will be worked out using the RPI figure for December 2017, even though the disposal takes place at a later date.

Assets acquired on or after 1 January 2018 will not attract any indexation allowance when they are disposed of.

HM Treasury say that this measure will align the treatment of chargeable gains made by companies with that for individuals and unincorporated businesses for whom the indexation allowance was abolished 10 years ago. It will also tie in the treatment of such disposals with disposals of other company assets that are not classified as chargeable (eg. intangible fixed assets).

This freezing of the indexation allowance represents a fundamental change to how corporation tax on gains is computed and is likely, over time, significantly to increase the tax charge arising to companies on their gains. Where reliefs are available to mitigate or eliminate a taxable gain (eg. rollover relief), the impact of the freeze may be negligible. However, particularly in the case of real estate holding entities where the substantial shareholding exemption (SSE) will not normally apply, the provision will further increase the chargeable gains arising on their disposals.

Depreciatory transactions within a group

The depreciatory transaction rules in S176 TCGA 1992 restrict any capital loss arising on the disposal of a subsidiary that has been created by what might be described as artificial means. Remember that capital losses are invariably computed ignoring any indexation relief.

A typical depreciatory transaction would be an intra-group disposal of a chargeable asset out of a subsidiary at an undervalue. Note that, if a company surrenders losses by way of group relief to a fellow group member but without asking for any compensating payment, this would, strictly speaking, be a depreciatory transaction but, in practice, HMRC never seek an adjustment in this situation (see letter dated 3 February 1981).

Any capital loss following a depreciatory transaction is reduced on a 'just and reasonable' basis that generally reflects the prior diminution in value of that subsidiary. It is important to stress that S176 TCGA 1992 can only be used to reduce or eliminate a capital loss – it cannot produce a gain. If the relevant disposal falls under the SSE rules, it is not necessary to identify prior depreciatory transactions given that any capital loss is disallowed under the SSE regime.

Since the enactment of FA 2011 on 19 July 2011, it has only been necessary to take account of depreciatory transactions occurring within six years before the relevant disposal. Depreciatory transactions that took place more than six years earlier are ignored.

Illustration

In December 2014, Christian Holdings plc acquired the entire share capital of Nicholas Properties Ltd (a property investment company) at a cost of £3,500,000.

In October 2016, Nicholas Properties Ltd transferred a freehold property to Christian Holdings plc for £710,000 when it was in fact worth £1,400,000.

Later, in August 2017, Christian Holdings plc sold its shares in Nicholas Properties Ltd for £2,700,000.

Since Nicholas Properties Ltd is not a trading company, this disposal falls outside the SSE. The allowable loss on the share disposal would be restricted as follows:

	£
Sale proceeds	2,700,000
Less: Cost	3,500,000

	(800,000)
Less: Depreciatory transaction adjustment (see below)	690,000

Allowable loss	£(110,000)

HMRC are likely to propose the following adjustment:

	£
Value of freehold property transferred	1,400,000
Less: Actual transfer value	710,000

S176(4) TCGA 1992 adjustment	£690,000

The Chancellor has decided that, for disposals of shares in a subsidiary made on or after 22 November 2017, the six-year time limit should be removed (CI 28 F(No2)B 2017). This means that, from now onwards, companies will have to consider the full history of the shares and will be required to make adjustments for any depreciatory transactions when calculating an allowable loss. In the case of a negligible value claim, the new rule will take effect where the negligible value claim is made on or after 22 November 2017 – this is the position even if the negligible value claim has been backdated to an earlier date.

Cl 28 F(No2)B 2017, which reverses the FA 2011 relaxation, ensures that companies cannot prevent the depreciatory transaction legislation from applying simply by retaining a subsidiary until after the six-year time limit has expired.

The need to consider depreciatory transactions has been a considerable compliance burden when calculating a capital loss on a disposal of shares or following a negligible value claim, given that there was originally a need to examine every asset transfer involving the company or group being sold. The FA 2011 introduction of a six-year restriction provided a welcome relief in this area and so, while the present Government's intention to tackle potential tax avoidance can be understood, in the vast majority of cases this latest amendment simply makes an already onerous compliance situation more difficult.

Postponed gains on foreign branch incorporations

Where the trade and assets of a UK company's foreign branch are transferred to an overseas company in exchange for shares in that company, existing legislation in S140 TCGA 1992 allows tax on any capital gains on such a disposal to be postponed. This postponement is, however, only temporary and lasts until:

- the overseas company sells the assets; or
- the UK company disposes of its shares in the overseas company other than in exchange for further shares during a corporate reorganisation.

An unintended consequence of these rules is that, if the shares exchanged during the reorganisation referred to above fall within the SSE regime, the postponed tax can become payable even though the UK group still owns the shares in the overseas company. The way in which the law is currently drafted means that such a transaction is viewed as a disposal – given that the SSE provisions take precedence over the reorganisation rules – and this has hitherto resulted in the crystallisation of the deferred gains.

For disposals of shares made from 22 November 2017, the Chancellor has amended the legislation so that such a reorganisation does not trigger the deferred gains (Cl 27 F(No2)B 2017).

The interaction of the SSE and the reorganisation rules has until now created a potential tax cost in what are essentially internal restructuring transactions and so the correction of this technical anomaly is to be welcomed. It had a particular impact on financial sector businesses which have traditionally operated through a network of foreign branches and which may subsequently need to restructure, for example, in order to meet changing regulatory requirements in the territories where they conduct their business.

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