CHAPTER 30

COMPANIES WITH INVESTMENT BUSINESS

30.1 Definition

A **company with investment business** is defined in the legislation as a "company whose business consists **wholly or partly** in the making of investments". CTA 2009, s. 1218

A company with investment business is not simply a company that holds investments or receives investment income. It is a company that has a **business** of making investments.

The term investment company is now only relevant when considering which companies may claim relief against income for capital losses on sales of certain shares. More on this later. CTA 2010, s.68

An **investment company** is a "company whose business consists **wholly or mainly** in the making of investments **and the principal part of whose income is derived therefrom**". CTA 2010, s.90(1)

HMRC, in Tax Bulletin 19, tell us to look at the totality of the company's functions and activities to identify a business wholly or partly in the making of investments.

Consider a flat management company that owns the freehold of a block of flats and all the flat owners have a share in the company. This type of company would **not** be treated as a company with investment business as its business is not that of making investments; its business is the provision of management services.

In the case of *Cook v the Medway Housing Society Limited* in 1997, it was held that a Housing Association purchasing property from a Local Authority and receiving rental income, with the aim of applying any profits to either buy more property or pass it to charity, **was an investment company**. This is because it had a business of making investments and had an intention of making a profitable return. It did not matter that the return was never going to be paid to the shareholders. The intention was enough for investment company status to apply.

We can contrast this with the case of *Tintern Close Residents Society Ltd*. In 1995 this company owned and managed an estate that consisted of 21 houses, 1 flat and 22 lock up garages. The company's income consisted of members' subscriptions and ground rents. It was held that the main function and activity of the company was the management and maintenance of the property. Although it had been formed to purchase land, it was not for the purpose of turning the land to profit.

In the case of *Jarrett v O'Neill and Brennan Construction Limited*, it was held that a company depositing funds into a bank account and receiving interest, did not constitute a business and therefore, for associated company purposes, it was treated as dormant.

30.2 Management expenses

The ability to claim management expenses has been extended to **include companies with an investment business** - not just those qualifying as investment companies - and also to include **non UK resident companies**.

The extension to companies with an investment business is important for companies who hold shares in subsidiaries as well as having their own trade.

Management expenses are deductible against the total profits of a company with an investment business. **The expenses will be deducted based on when they are debited in the accounts.** The accounts must be drawn up in accordance with GAAP. Where the period of account exceeds twelve months, management expenses will be time apportioned. CTA 2009, s. 1224

No expenses can be deducted as management expenses if they are **otherwise deductible for tax.** CTA 2009, s. 1219(3)

Expenses of a capital nature are not management expenses, unless they relate to capital allowances. Thus for the first time there is statutory authority to exclude capital expenditure from management expenses. This has arisen as a result of case law in this area, as we shall see below. CTA 2009, s. 1219(3))

Expenses will only qualify for a deduction to the extent that they are made in respect of the company's investment business and to the extent that they are **not made for an unallowable purpose**. CTA 2009, s.1219 (2)

An investment is held for **an unallowable purpose** to the extent that it is not held for a business or other commercial purpose, or is held for activities outside the charge to corporation tax. This will exclude investments held for social or recreational purposes and investments of a non resident company with a permanent establishment ("PE") in the UK, if the investment is not part of the business of the PE.

Surplus capital allowances are added to management expenses.

Examples of management expenses include:

(i) **Commissions paid to agents**, such as stockbrokers who manage the portfolio of shares;

(ii) **Capital allowances on plant used to manage the investments**, such as computer equipment used to monitor the progress of the investments;

(iii) **Reasonable salaries**, which includes redundancy costs. HMRC may seek to disallow excessive directors' remuneration where it cannot be justified given the amount of input the directors have in managing the investments against the return derived from them. If HMRC feel the amount is excessive, they will seek to disallow some management expenses. However, they will still tax the director's full salary and subject the company to Class 1 secondary National Insurance on the salary being paid;

(iv) **Premises costs**, for instance relating to the offices used to manage the investments;

(v) **Audit and accountancy costs**.

Remember that **commitment fees and guarantee commissions**, are part of the cost of raising loans, and so are not management expenses - they will be deductible under the **loan relationships** rules.

Any expenses relating to specific income must be set against that source only, for example a UK property business. Expenses relating specifically to properties being let out must be set against the UK property business income, not treated as a management expense.

All Intangible Fixed Assets held will be held for **non-trading purposes**. Royalty payments and receipts will be dealt with under the rules for Intangible Fixed Assets.

30.3 Management expenses case law

In *Capital and National Trust Ltd v Golder* the point at issue was whether the company could claim relief for brokerage and stamp duties as management expenses. It was held that these sums were not allowable as management expenses.

The reason was that, where investments are being changed, 'management' does not extend beyond the time when a purchase or sale is effected. Therefore, expenditure after that time **cannot** be an expense of management; it is 'an integral part of the selling price'.

Sun Life Assurance Society v Davidson also looked at the issue of whether the company could claim relief for brokerage and stamp duties as management expenses. The company was a **life assurance company**. It included in its management expenses claim sums for brokerage and stamp duties in connection with purchases and sales of investments. Sun Life sought to distinguish its business from that of Capital and National Trust Ltd because, it said, buying and selling stocks and shares was part of its trading activity. It was decided that these sums were not allowable as management expenses. They concluded that the brokerage and stamp duties were not general expenses of conducting the Society's business, but expenses of the purchase of investment.

Although the judgements in these two cases perhaps say more about what is **not** an expense of management, there are three broad points that are worth noting.

- The words have no special meaning.
- The phrase does not include every expense.
- The phrase should be given a 'wide' meaning.

In another case it was stated that the purpose of management expenses is not to give investment companies an advantage over trading companies, but simply to prevent them being at a disadvantage.

So we need to draw a distinction between the costs of a **change** in a company's investments, (including its share portfolio) and the **acquisition** of the share capital of a new subsidiary company, as part of the expansion of the group. The costs of a **change** in the company's investments **may** be allowable on the authority in the *Sun Life* case. The **costs of acquisition of the share capital of a new subsidiary company are not management expenses**.

Thus when we are looking at the purchase of a company by a company with investment business, we have to consider each stage in the procedure. To begin with, the company may be looking at several companies and so at this stage the costs incurred will be in relation to making and managing its investments. However, at some point when a specific target is identified, the costs such as due diligence will become part of the capital cost of purchase.

HMRC have recently lost a case of *Camis v Atkinson* at the Court of Appeal. In this case a company incurred substantial expenditure in evaluating a projected acquisition of another company. The company did not proceed with the acquisition, and claimed relief for the expenditure as management expenses. The Court of Appeal held that the relevant activities 'were all part of the process of managerial decision-making' and that capital expenditure was not excluded by the legislation as in force at the relevant time.

This decision was taken before FA 2004 was passed. As we have seen above, the s1219(3) now states that expenses of a capital nature are excluded from deduction as management expenses.

In the case of *James Snook and Co v Blasdale,* a trading company was bought. As part of the takeover, the existing directors agreed to resign. They were paid compensation for loss of office. It was held that the cost was not deductible as it was too closely linked with the takeover of the company and thus formed part of the capital cost of the takeover.

30.4 Relief for management expenses

Management expenses are **automatically set against investment income and gains in the current accounting period**. This relief is automatic and compulsory.

Management expenses are deducted **before charges on income** and before any **loss relief** claims under section CTA 2010, s.37.

Where the management expenses **exceed the gross income and gains in the current period**, they are **"excess".** If the company is part of a group they **may be transferred to a fellow 75% owned company**, upon making a claim.

Failing that, excess management expenses are **carried forward** and set against future income and gains of the company. CTA 2009, s.1223

At the end of the chapter you will find a pro forma for an investment company showing the relief for current year management expenses.

30.5 Change in ownership provisions

CTA 2010, s.677

We must also be aware of the change in ownership provisions for a company with investment business. Anti-avoidance provisions apply to **prevent the carry forward** of excess management expenses in prescribed circumstances.

If in the three years leading up to the change in ownership, or in the three years following the change in ownership, there has been a **major change in the type of investments held,** then excess management expenses will be stopped at the date of change in ownership.

For example, if before the change in ownership the company held quoted securities and following the change, it held commercial property, HMRC would view this as a major change in the type of investment held. However, let us say that before the change of ownership, the company held quoted securities but afterwards, it held a different portfolio of quoted securities, so it sold the previous holdings and replaced them with different ones. This is unlikely to be treated as a major change because the company essentially is still holding the same type of investments, that being quoted securities.
The anti-avoidance provisions also apply when a company's activities are **small and negligible prior to the change in ownership,** and they are **followed by a considerable revival.** Excess management expenses will stop at the date of the change. This will be based on the facts and degree in each individual case but we need to look at the number of transactions taking place each year, before and after the change in ownership.

In addition, **a significant increase in the capital of the company in the three years immediately following the change of ownership,** will give rise to a loss of excess management expenses. A significant increase is the lower of the company's capital doubling in the first three years, or the capital increasing by £1 million in the first three years.

Illustration 1

The share capital of a company with investment business before the change of ownership is £200,000 and in the first three years following the change, it increases to £500,000. The capital has more than doubled and therefore it has given rise to a significant change.

Taking another company with investment business, let us say its share capital before the change is £2 million and in the three years following the change, it increases to £3 million. Although the capital has not doubled, it has increased by £1 million and this will be seen as a significant increase and excess management expenses will be lost.

30.6 Loan interest

Interest paid by companies with investment business on loans taken out to purchase investments is a **loan relationships debit**. The tax treatment and relief for loan relationship debits was covered in the earlier chapter on relief for other losses.

Remember such interest is never treated as a UK property business expense or a management expense.

Commitment fees and guarantee commissions, are part of the cost of raising loans, and not management expenses. They will be covered by the loan relationship rules.

30.7 Close investment holding companies (CIHCs)

CTA 2010, s.34

A CIHC is any close company (i.e. one under the control of 5 or fewer shareholders) that does **not** exist wholly or mainly for one of the following purposes;

(i) carrying on a **trade** or trades on a commercial basis;
(ii) making investments in land and **letting the land to unconnected** persons;
(iii) holding shares and securities or making loans to group companies;
(iv) co-ordinating the administration of group companies;
(v) being a member of a trading group;
(vi) being the investment company in a group.

All of the profits of a CIHC are **charged at the full rate** of corporation tax (currently 28%, for FY 2011 27%).

30.8 Losses on sale of shares

Where an investment company makes a capital loss on the disposal of shares in certain qualifying companies, it may claim to **set that loss against income**.

On making a claim within two years of the end of the accounting period of the loss, the loss can be set against income for the **accounting period of the loss**, and if necessary any **previous accounting period ending in the 12 months before** the start of the accounting period of the loss. This loss relief is claimed before any other deductions including management expenses and charges. However, claims under the CVS rules take priority. CTA 2010, s.68

To be able to make the CTA 2010, s.68 claim, the company **must be an investment company** and have been so throughout a continuous period of six years. If this is not the case it must not previously have been a trading company. The company must have **subscribed for shares in a qualifying trading company** (as defined by the EIS rules), which has not been associated with it from the date of subscription to the date of disposal. Associated here is the wide meaning of control.

Note that this relief can **only be claimed by investment companies**. It does **not extend to companies with an investment business.**