Quick guide to corporation tax

Introduction
Corporation tax is paid by companies and other bodies on their profits and capital gains (called chargeable gains). Other bodies include clubs and associations, but not trusts or partnerships.

Corporation tax is an alternative to income tax and capital gains tax. However, there are many provisions of corporation tax that are the same as for income tax and capital gains tax.

Basis of charge
Corporation tax is charged for accounting periods. These are usually of one year, apart from in the year that the company starts and ceases, and if there is a change of accounting date. If this spans a change in rate, the period must be apportioned between the periods for each rate.

The tax is charged on the **adjusted profit**. This is the figure shown in the accounts as net profit before tax and dividends. To this various adjustments are made to bring the figure into line with tax law.

The **accounts** must have been prepared in accordance with generally accepted accounting principles. This includes complying with all accounting standards, and producing a true and fair view.

Some of the common changes need to bring net profit to adjusted profit are:

- depreciation is added back and capital allowances deducted,
- disallowed items are added back (see below),
- stock taken for personal use is treated as a sale at normal price,
- any deductions that represent provisions or reserves is added back.

Disallowed items include:

- items for personal use rather than business use,
- entertainment of clients (but not of staff),
- payments of fines, penalties and any crime-related payments,
- capital expenditure (though capital allowances may be claimed).
- dividends paid to shareholders.

Rates
There are two rates of corporation tax:

- the main rate, and
- the small profits rate.

Before April 2010, the small profits rate was called the small companies rate.

The rates are charged for a **financial year** which runs from 1 April to the following 31 March. So Financial Year 2011 means the period from 1 April 2011 to 31 March 2012.

These are the rates for recent years:

Financial year	Main rate	Small profits rate
2011	26%	20%
2010	28%	21%
2009	28%	21%
2008	28%	21%
2007	30%	20%
2006	30%	19%

Rates for all previous years back to the tax's introduction in 1965 are given in *Rates of corporation tax.*

The present Chancellor has said that he intends to cut the main rate by one percentage point each year until it reaches 23% by 2014. No statement has been made about the small profits rate.

The **main rate** is paid on *all* profits if they exceed £1.5 million in 2011. So if a company makes an adjusted profit of £10 million, it pays tax of £2.6 million.

The **small profits rate** is paid on all profits if they are less than £300,000. (It was less correctly called small companies rate before 1 April 2010.)

Note that corporation tax is charged on the *whole* of taxable profits. It is not charged on slices of income, like income tax.

Marginal relief and rates

For profits between £300,000 and £1.5 million, corporation tax is calculated at the main rate minus **marginal relief**.

Marginal relief is calculated as:

$$\text{Marginal relief} = (\text{Upper limit} - \text{Augmented Profits}) \times \frac{\text{Total Profits}}{\text{Augmented Profits}} \times \text{Standard Fraction}$$

Augmented profits means the company's total profits (as adjusted for corporation tax) *plus* franked investment income from outside its group. Franked investment income basically just means taxed dividends. From 1 June 2009 this includes foreign dividends. Augmented profits was previously known simply as "profits". The Upper Limit is £1.5 million. The Standard Fraction for financial year 2011 is 3/200.

What this means is that the rate that applies for profits between £300,000 and £1.5 million is somewhere between 20% and 26%.

Mathematically, the **marginal rate** in this band is 27.5%. This means that every *extra* £100 profit *between these limits* results in another £27.50 corporation tax.

This can be shown if we imagine a company with taxable total profit of £1 million. It has no franked investment income, so its augmented profits are also £1 million.

The marginal relief is

(£1.5 million - £1 million) x 3/200

= £500,000 x 3/200

= £7,500

So the corporation tax payable is £1 million taxed at 26% less marginal relief:

£1 million x 26% =	£260,000
less marginal relief =	£7,500
Corporation tax	£252,500

And that is the proper and official way to calculate corporation tax.

Mathematically, we achieve the same answer if we tax the slice up to £300,000 at the small company's rate and the balance at the marginal rate. (This only works if there is no franked investment income.)

£300,000 at 20%	=	£60,000
£700,000 at 27.5%	=	£192,250
£1 million tax at		£252,250

In practice, you use marginal relief to calculate corporation tax, and the marginal rate for tax planning.

The standard fractions and marginal rates for recent years are:

Financial year	Standard fraction	Marginal rate
2011	3/200	27.5%
2010	7/400	29.75%
2009	7/400	29.75%
2008	7/400	29.75%
2007	1/40	32.5%
2006	11/400	32.75%

The rate for a **loan to participators** in a close company is 25%.

Chargeable gains

Chargeable gains are capital gains made by a body subject to corporation tax.

Only the gain that has accrued since April 1982 is taxed. The basis of the charge is disposal proceeds less acquisition cost. Both of these include relevant expenses, such as legal fees, installation, delivery, advertising and the suchlike. Such expenses cannot be claimed as revenue expenses.

The acquisition cost is index using the retail prices index to remove the element of inflation during the period of ownership. The acquisition cost is multiplied by the index for the month of disposal and multiplied by the index for the month of acquisition.

For example, a company buys premises for £1 million in January 1989 (index = 111.0), and sells it for £3 million in January 2010 (index = 217.9)

The acquision cost is uplifted by 217.9/111.0 to £1,963,063.

The indexed chargeable gain is therefore:

disposal proceeds:	£3,000,000
indexed acquisition cost:	£1,963,063
chargeable gain	£1,036,937

In this example, indexation has almost halved the chargeable gain.

Associated companies

Two companies are associated if either one owns the other, or they are both owned by the same company or individuals or an individual's close relation. For a group of individuals, it is necessary to consider the "minimum controlling combination". Where two close relations each own a business, from 1 April 2011, they are only considered associated if there is a measure of interdependence between them. Previously a similar provision was contained in extra-statutory concession C9.

Where two or more companies are associated, various thresholds are divided by the number of companies.

So if three companies are associated, the £300,000 and £1.5 million thresholds for corporation tax rates become £100,000 and £500,000 for each company.

Groups

A company and its subsidiaries may form a **group** for the purposes of corporation tax (and also for accounting purposes and VAT).

The broad consequence of forming a group is that all companies in it are regarded as being one entity. This means that trades between group members must be eliminated, sums owed to each other are removed, dividends are paid to each other without any tax deducted or tax credit, and assets may move freely without any tax consequences. All this should be reflected in the consolidated accounts.

It also means that a loss made by one company in the group may (subject to exceptions) be offset against profits earned by another. This is imaginatively called **group relief.**

In general, group relief can only pass between companies where one owns 75% of the other, or they are both 75% owned by a third.

A company may claim **substantial shareholding exemption** if it disposes of shares in a company where it has held at least 10% of the share capital for 12 months.

There are many anti-avoidance provisions to prevent groups being used for artificial tax avoidance.

Transfer pricing

Suppose a company has a subsidiary making engines in a country where there is no equivalent to corporation tax, or a much lower rate. It costs them £2,000 to make an engine, which they sell for £3,000.

Another subsidiary in the UK, buys this engines for a transfer price of £3,000, and spends another £2,000 turning them into machines which it sells for £6,000.

Overall the group has made £2,000 profit on a £6,000 sale. Of this £1,000 is subject to UK tax and £1,000 to foreign tax (if any).

However as both companies are under common control, they could be directed to sell the engines to the UK subsidiary for £4,000 instead of £3,000. The common would still make £2,000 profit, but it would all fall overseas and avoid UK tax.

To prevent this, there are **transfer pricing** regulations that can require the market value to be substituted for the transfer price where the latter has been adjusted for an unfair tax advantage.

Administration

Corporation tax was introduced in 1965, before which companies paid income tax and profits tax.

The current law is largely contained in Corporation Tax Act 2009 and Corporation Tax Act 2010 which consolidates previous law. Many of the provisions for chargeable gains are contained in Taxation of Chargeable Gains Act 1992.

Generally corporation tax is payable nine months and one day afte the end of the accounting period. However the return does not have to be submitted until 12 months from the end of the return period.

From 1 April 2011, all corporation tax returns must be filed on-line, and tagged using iXBRL.

Companies paying tax at the full rate must pay their corporation tax in instalments. These are due in months 7, 10, 13 and 16 of the accounting period. This means that the first two must be calculated on estimated profits. The last two are paid after the accounting period has ended. A company is excused payment by instalments if their corporation tax liabilities are less than £10,000. Any balance is paid nine months after the year-end, that is in month 21.

Late payment attracts the usual array of penalties and interest. There are the usual rights of appeal to tax tribunals.