THE ASSOCIATED COMPANIES RULES

Graeme Blair discusses the changes made by Finance Act 2011

The number of associated companies determines effective rates of corporation tax and the extent to which tax is paid by quarterly instalment.

The definition of an associated company is wide and this has led to unintended consequences. Over the last three years there has been public consultation and private discussion between HMRC and representatives of the tax community over this definition. This process has led to Finance Act 2011 (FA 2011) revising the definition.

The way that the associated companies legislation has historically been written has caused difficulties which HMRC has resolved on a piecemeal basis. The amendments included within FA 2011 consolidate some of those revisions and improve on others.

Although the historical difficulties arising from the definition of association precede Corporation Tax Act 2010 (CTA 2010), my observations will use the CTA 2010 statutory references.

From s 25 we know that the definition of an associated company includes companies 'under the control of the same person or persons'. Control is defined at ss 450 and 451. Section 451 attributes to a person the rights of any associates, with an associate being defined at s 448. That definition covers a broad range of persons including certain family members and business partners. The broad definition led to HMRC issuing Extra-Statutory Concession (ESC) C9 which sought to reduce the extent to which family members were brought into it.

A number of years ago partners (primarily in film partnerships) started to receive what were colloquially termed Wick letters, so called because they originated from the tax office in Wick, Scotland. The Wick letters highlighted that the definition of an associated company includes those companies under the control of business partners, and therefore that there should be attributed to the partner all companies owned by his fellow partners. In an investment scenario, such as a film partnership, it is not common for the partners to be aware of the names of their co-investors, let alone know the number of companies that their co-investors may control. The Wick letters led to consternation within the tax community and resulted in s 27, CTA 2010, whose impact is to exclude attribution of partners' interests other than in tax-reducing structures.

In my mind the problems arising on the associated companies test have all been due to ss 448, 450 and 451. These sections are the rewrite of ss 416 and 417, Income and Corporation Taxes Act 1988 (ICTA 1988) which contained broad brush definitions for certain anti-avoidance purposes. Application of those broad brush anti-avoidance definitions to the associated companies test led to unexpected consequences and hence the issue of ESC C9 and the Wick letters and the consultation of recent periods.

Section 55, FA 2011 inserts a revised s 27 in CTA 2010. The wording has a dramatic impact on the logic that one applies to determine which companies are associated for these purposes.

Applying the (new) s 27 is a two stage process:

- First, determine the companies which are under the control of a person or persons (without any of their associates).
- Second, determine if those companies have 'substantial commercial interdependence'.

If the companies identified at stage one have no substantial commercial interdependence with any other companies, then that is the end of the matter and the number of associated companies has been determined.

To the extent that companies identified in stage one have substantial commercial interdependence with companies controlled by the associates of the person or persons, then those latter companies are associated for the small profits rate test. The definition of associate is the expansive definition at s 448. Although the expansive definition of an associate is used, the companies which could be associated are only those where there is substantial commercial interdependence. If there is no substantial commercial interdependence then companies owned by an associate of the shareholder are ignored. For example, should a husband and wife each own 100% of a company with those two companies operating entirely separately with no commonality, they will not be associated. This is an improvement on the historical position.

The key to determining the number of associated companies is therefore to understand the extent that businesses have substantial commercial interdependence. Although this expression was first used in ESC C9, there is no statutory definition of it. Section 27 (as revised) anticipates a Treasury Order to identify matters which are deemed to lead to substantial commercial interdependence.

In this regard the Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Order 2011, SI 2011/1784 comes into play. That Order says that the factors to be taken into account are the degree to which the companies are interdependent financially, economically or organisationally. Only one of the three types of link is required to make companies associated.

- Financial interdependence is a reflection of the extent that one company gives financial support (directly or indirectly) to the other.
- Economic interdependence is a review of the economic objectives, activities and customer base of the businesses.
- Organisational interdependence reviews the extent that the companies have common management, common employees, common premises or common equipment.

HMRC accepts that these terms are not precise and are dependent on facts and circumstances. To this end they have issued draft guidance which, in time, will become CTM03750 to CTM03800 inclusive in HMRC's *Company Taxation Manual*. The guidance gives 13 examples and explains why the companies are or are not associated within those examples. Some of the scenarios are obvious and clearly show what HMRC is driving at. They clearly demonstrate that past association (which is no longer present) does not mean ongoing association and that individuals as close as husband and wife operating in the same business sector (but entirely independently) do not lead to association.

My main concern is that some of HMRC's scenarios are so complex with so many features that it is difficult to identify which feature or features is specifically leading to the association. Another concern is that a number of the examples lead to HMRC concluding that, 'the two companies are likely to be associated'. Although I acknowledge it is the facts and circumstances which lead to association I cannot help feeling that the matter is made more complex by scenarios which do not categorically confirm if an association exists! I foresee that advisers will become well acquainted with the 13 examples as they determine how their clients' tax liabilities may vary now that Finance Act 2011 has become legislation.

Section 27 revolves around, '**substantial** [my emphasis] commercial interdependence'. There is little commentary on the definition of the meaning of substantial for these purposes. CTM03780 does mention that one should have regard to the degree of interdependence and the period of time during the accounting period for which the interdependence exists. It states, 'for example a loan between companies that existed for only a week is unlikely to indicate substantial commercial interdependence regardless of its size'. I can see many advisers scratching their heads as to the definition of substantial and concluding that disclosure accompanying the return is the only protection against future enquiries.

As well as providing scenarios to expand on the interdependence thread, CTM03800 states that HMRC does not consider substantial commercial interdependence to arise where there is, 'accident of circumstance' and not, 'in a real sense, interdependence between the parties'. Again I can see this leading to much disclosure.

The FA 2011, and therefore the changes to the definition of association, applies to accounting periods ending on or after 1 April 2011. HMRC acknowledges that the removal of the partners association carve-out that was granted in the 'old' s 27 could theoretically mean that some companies are disadvantaged by the new rules. HMRC's draft guidance goes on to give an example of a situation where this is possible. To overcome this theoretical increase in the number of associated companies, a company can elect to delay the impact of the legislation until the first accounting period starting after 1 April 2011 (s 27(3)).

In conclusion, the difficulties which have arisen from the historical definition of association have been removed by amendment to s 27, CTA 2010. New problems may arise as advisers attempt to dissect HMRC's 13 examples of substantial commercial interdependence and this may lead to increased disclosure accompanying the tax returns.

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