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A Brave New World?

Management Expenses

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Pete Miller welcomes the new régime for management expenses contained in this year’s Finance Bill.

One of the more welcome changes in this year’s Finance Bill was the revised régime for management expenses. This had been well trailed beforehand, with draft clauses being published in December 2003, but there were some changes in the draft clauses in response to consultation.

The purpose of this article is to introduce the new régime to a wider audience and to explain the policy behind it. However, as a corporation tax adviser with no material experience of the insurance tax rules, I shall not be attempting to explain the new rules as they apply to insurance companies.

A little history

Historically, expenses of management (section 75, Taxes Act 1988) have only been available to companies that satisfied the test in section 130, Taxes Act 1988, of being investment companies. This definition refers to a company ‘whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom’. The original régime for management expenses was intended to allow investment companies tax relief for the legitimate costs of their investment business. However, the result of the régime that we have all known for so long has been to restrict the availability of management expenses only to companies that have ‘wholly or mainly’ investment businesses, that is, those companies with no more than a small component of non-investment business. Strictly, no relief for management expenses was available:

- for companies with some investment and some trading activity;

- for those with mainly trading activity and some investment activity; or arguably

- for those group holding companies with both investment and group stewardship roles. (This last is an argument that I have had on a few occasions, both as an Inland Revenue Inspector and since, with varying degrees of success.)
The régime for management expenses was, therefore, seen by most people as manifestly unfair and as having an adverse effect on business. Many groups were forced to organise themselves in specific ways in order to be able to get relief for their legitimate business expenses, usually by segregating the investment activities into special purpose companies. Even the Revenue understood that the system was imperfect, but it has nevertheless been allowed to stand for many decades.

Why the changes?

The first inklings of the possibility of change came in the August 2002 consultation paper on the reform of corporation tax. In section 5 of that document, looking at the differences between trading companies and investment companies, there was explicit recognition that the old régime for management expenses was widely seen as unfair and divisive, and comments were sought on ways to improve the régime.

A more detailed consultation document on the reform of corporation tax was published in August 2003, which *inter alia* accepted that some rationalisation of the management expenses régime was 'a particular priority' to which 'business attaches considerable importance'. This was followed, on 10 December 2003, by a 'next steps' technical paper with a specific commitment to two priority issues for Finance Bill 2004, one being the extension of the relief for management expenses and the other, less fortunately, being the extension of the thin capitalisation and transfer pricing rules. The paper contained draft clauses and explanatory notes, which formed the basis for the clauses in the Finance Bill.

It is interesting that after so many years of doing nothing about management expenses, the Revenue refers specifically in the paper to 'outdated and unnecessary restrictions that currently force companies to adopt uncommercial structures'! Furthermore, in singing its own praises, the Revenue's news release PN 4, published on Budget day, said, in the context of management expenses, 'The Government is committed to a modern, fair and competitive corporation tax system that reflects the increasingly flexible and global business environment'.

The new régime

Under the new régime, there are four major changes in the new legislation.

- The first change extends relief for management expenses to companies 'with investment business'.

- The second is that the relief will be on an accruals basis, where hitherto it has been on a disbursed basis.

- The third is that the régime is now open to non-United Kingdom resident companies, that is, to United Kingdom branch activities of such companies.

- Finally, appeals on management expenses issues can now be to the General Commissioners and do not need to be to the Special Commissioners, as before.

The legislation is contained in clauses 38 to 45 of the Finance Bill and introduces new sections 75, 75A, 75B and 76 to the Taxes Act 1988, along with a number of consequential amendments in Schedule 6.

As well as the Finance Bill and explanatory notes, the Revenue published some helpful guidance notes on
the operation of part of the new legislation.

**The basic rules**

The basic rule is encompassed entirely within the new section 75(1), Taxes Act 1988, which reads:

\[ \text{'In computing for the purposes of corporation tax the total profits for an accounting period of a company with investment business ... a deduction is to be allowed for any expenses of management of the company's investment business ... which are referable to that accounting period...'} \]

It looks simple enough, but let's break that down a little further to help us understand the detail.

The first new definition to get to grips with is that of a 'company with investment business'. This is inserted into section 130, Taxes Act 1988, and means any company whose business consists wholly or partly in the making of investments. So, very simply, 'wholly or mainly' has become 'wholly or partly', and we are already most of the way to where we want to be. The explanatory notes state that the phrase 'making of investments' is deliberately left in place as it has been considered by the courts in the past and can therefore continue to take the same meaning in the slightly different new context.

Intriguingly, nothing is said about the company's income from investments, in contrast to the requirement that an investment company derives the principal part of its income from its investment activities. So, in theory, a company with investment business might derive no income from its investment business and would therefore be able to deduct all the expenses of managing that business from its other profits for the accounting period. The investment will still, however, have to be held for a commercial purpose.

The old definition of an investment company remains in place for the purposes of the transitional rules and also for the purposes of section 573, Taxes Act 1988.

The phrase 'expenses of management' is left in place from the old section 75, so that taxpayers and the Revenue can rely on established jurisprudence on the meaning of this phrase.

Clause 38 then defines the 'expenses of management of the company's investment business' as being 'in respect of so much of the company's business as consists in the making of investments'. This phrase is fairly clear in its meaning and is not defined further, nor referred to in the explanatory notes. New section 75(10) ensures that any apportionment required, if expenses are incurred partly for the investment business and partly for another purpose, shall be made on a 'just and reasonable basis'.

**Exclusions**

Not surprisingly, there are a number of exclusions from the new régime, many of which mirror the old rules.

First, expenses are not allowable under section 75 to the extent that they are allowable under some other provisions of the Tax Acts. So trading or Schedule A expenses cannot be allowed as management expenses.

There is also no deduction for capital expenses, except in respect of surplus capital allowances (or as otherwise provided by legislation). This important area is discussed later in the article.

Management expenses are not allowable to the extent that they relate to the management of investments held for 'an unallowable purpose'. This means 'for a purpose that is not a business or other commercial purpose of the company, or for the purpose of activities in respect of which the company is not within the
charge to corporation tax'. The examples in the explanatory notes suggest that the first leg would exclude investments held for social or recreational purposes, and the second leg would exclude, for example, expenses relating to the non-United Kingdom activities of a company with a United Kingdom permanent establishment. Strangely, the notes also refer to 'trades undertaken on a mutual basis'. I assume this should refer to investment activities undertaken on a mutual basis.

The separate guidance notes make the point that the exclusion for non-business or non-commercial investments is likely to be in point only rarely, since 'in the case of most investments of a company existing for commercial purposes, it is difficult to envisage any non-commercial purpose for which the investments may be held' ('Guidance for management expenses', published on the Revenue website on 8 April 2004). It is more likely to be seen in the context of privately-held groups, where the shareholders are less likely to object to an investment in the football club supported by a director (to use the Revenue's own example).

The Revenue’s explanation of its position on holdings of shares is very helpful. We are told that the test of being within the charge to corporation tax is one that is not failed just because the investment is in shares where the dividends are outside the scope of corporation tax by section 208, Taxes Act 1988, or where gains on disposal are exempt under the substantial shareholdings exemption (or other provisions) or where the investment is in shares in a company whose activities are themselves outside the charge to corporation tax. For example, as an investment, a company might hold shares in a non-United Kingdom company, so the profits of the investee company are outside the United Kingdom tax net. But the expenses of managing that investment will still be allowable, so long as the investment is held for a business or commercial purpose and the investing company is within the scope of United Kingdom corporation tax.

The last minor exclusion mirrors the old rules. Management expenses are to be reduced by income ‘derived from a source not charged to tax’ held in the course of the company’s investment business. This includes non-taxable income of a United Kingdom permanent establishment of a non-resident company, where the source of the income is held as part of the permanent establishment’s investment business. The restriction for certain regional development grants is not reproduced, as such grants are no longer made.

**Capital expenses**

The exclusion for capital expenses in new section 75(3) is new to management expenses legislation. In the explanatory notes, the Revenue says that this is to give statutory force to its long-held view that capital expenditure cannot be an expense of management. But the Revenue also notes that the High Court had ruled against it in the current case of *Camas v Atkinson* [2003] STC 968, involving abortive acquisition expenditure, and the Court of Appeal has also now found against the Revenue. The High Court judgment found specifically that neither the legislative history of the old section 75 nor the authorities supported the Revenue’s proposition that capital expenditure cannot be a management expense. At the time of writing, no details are available as to the *ratio decidendi* of the Court of Appeal. Nevertheless, the Revenue has now enshrined its position in statute.

The Revenue’s specific guidance on the operation of section 75(3) reiterates that capital expenditure is not deductible in income computations. It accepts that general research into potential targets for investment can also be an expense of management. But it draws the line at the point ‘when a specific capital investment is identified, and the Revenue view is that, from that time on, the costs are capital costs and not severable from the costs of acquisition of that investment’. The notes go on specifically to exclude the costs of, for example, evaluating the impact of the acquisition or carrying out due diligence as costs that arise after identification of the target.

It is arguable that section 75(3) does not actually add anything to the debate. In general, business has always accepted that the capital costs of acquiring a capital asset are not deductible as management expenses, and the disputes with the Revenue in this area are usually based on when, for a particular purchaser company or group, the process of general research, investment management, and so on, ceases and the process of acquisition starts. In other words, the debate is over when the revenue-capital line is crossed, so there is no reason to think that imposing a general exclusion for capital expenditure will do
anything to clarify the position as to when revenue expenditure becomes capital expenditure. The guidance notes have no statutory force, so they cannot be used by the Revenue as the basis for refusing all due diligence costs, for example. In some groups, it may be common practice to carry out a limited exercise before deciding whether to proceed with an acquisition: such groups would no doubt contend that such exercises are merely part of their general day-to-day expenses of making and managing investments.

This point was also debated by Standing Committee. The Paymaster General, Dawn Primarolo, stated that the new provision is intended to align management expenses with trading deductions, by excluding capital expenditure from both. Ms Primarolo said that the Revenue has always argued for its view of the law, that capital expenditure could not be a management expense, and the clause was ‘in line with that view’ and ‘not intended to restrict relief’.

Overall, it may be that section 75(3) is something of a toothless tiger, with companies still being able to rely on established jurisprudence (including, as things stand, the Camas case).

Just to complete the picture, the guidance tells us that expenditure on an abortive acquisition is treated the same as on a successful acquisition. If it is expenditure in the capital phase of an acquisition, then it is not allowable, otherwise it is capable of being an expense of management. Similarly, expenses of a disposal are to be disallowed as capital after the point when ‘a particular investment has been identified for disposal in some way’. Again, neither of these is particularly controversial, except that the Revenue seems likely to take a different view from business as to when the capital phase of a transaction actually starts.

Other provisions

The capital allowances rule is preserved in the new legislation, so that management expenses are increased by surplus capital allowances on machinery and plant.

Surplus management expenses, the excess over total profits against which they can be relieved in an accounting period, are carried forward to the succeeding accounting period and treated as management expenses of that later accounting period. Surplus charges on income, now restricted to those paid for the purposes of the company’s investment business, are also carried forward as management expenses of the later accounting period.

Management expenses carried forward from a pre-commencement accounting period under the old régime are to be treated as if they were management expenses brought forward under the new régime.

As noted above, any apportionments required by section 75 shall be made on a just and reasonable basis.

Finally, there is no longer a requirement for the Special Commissioners to hear appeals relating to management expenses. So the general rules apply and the General Commissioners can hear such appeals, too.

Which accounting period?

The new section 75A, Taxes Act 1988 introduces the accruals basis for management expenses where previously management expenses were allowable on a disbursed basis, so that deductions were due when the expenses had effectively been paid out, in contrast to the accruals basis of relief for the expenses of trading companies. This appears to be a major change at first glance but, in practice, anecdotal evidence indicates that Inspectors have been accepting an accruals-like basis for management expenses in recent years.

The legislation appears to be pretty straightforward. Essentially, management expenses are deductible for the accounting period for the period of account in which they are debited in the accounts. This can be in the
profit and loss account or the statement of total recognised gains and losses, so long as the debit is in line
with United Kingdom generally accepted accounting practice. Where a period of account and an accounting
period do not coincide, the debits shall be time apportioned to accounting periods, unless this would lead to
an unjust or unreasonable result, in which case a just and reasonable basis may be substituted.

Where these basic rules cannot be applied, management expenses are to be allowed in the accounting
period in which they would have been debited in accounts for an accounting period drawn up according to
generally accepted accounting practice.

Now that the accruals basis applies, there have to be rules for reversing management expenses already
claimed, in cases where the accounting entry is reversed. These rules are in the new section 75B, Taxes Act

The basic rule is that if a credit is brought into account, in accordance with generally accepted accounting
practice, in an accounting period after that in which a corresponding debit has been relieved as management
expenses, the credit shall reduce the available management expenses for the period in which it arises. If the
credit is greater than the management expenses for the accounting period, the surplus is charged as income
under Case VI of Schedule D.

For some reason, this rule excludes management expenses brought forward under new section 75(9), Taxes
Act 1988. So the surplus of credits over management expenses is the surplus of current year reversals over
current year management expenses only. As a result, it is possible for a company to have, in the same
accounting period, both a credit chargeable under section 75B(7)(b) and also management expenses
brought forward from an earlier accounting period and relievable against total income of the current
accounting period (including, presumably, the Schedule D, Case VI credit).

A credit reverses a debit both where a sum is paid and then repaid and where it is never paid.

As for debits, if the period of account and the accounting period do not coincide, the credit shall be time
apportioned, although there is provision for a just and reasonable override if necessary. There are rules in
section 75B similar to those in section 75A for cases where accounts are not drawn up for a period or do not
conform to generally accepted accounting practice.

**Commencement**

The new régime is already in place, having taken effect for all accounting periods starting on or after 1 April
2004.

Where an accounting period of a company straddles that date, the accounting period is notionally split into a
pre-commencement accounting period and a post-commencement accounting period, so making the relief
available to all companies from 1 April 2004.

**Transitional rules**

There are provisions to ensure that management expenses are allowed only once, but also do not fall out of
account. So, expenses disbursed pre-April 2004, but brought into account under generally accepted
accounting practice after commencement, shall not be allowed again under the new rules. Amounts brought
into account pre-commencement, but not disbursed, shall be allowed in the first accounting period of the new
régime.

Where, during a straddling accounting period, there is a change of ownership of a company, such that
section 768B or 768C might apply, the straddling accounting period rules are to be applied first, in
determining the apportionment of management expenses into pre- and post-commencement periods. Then
the appropriate notional accounting period is subjected to the section 768B or C rules, to the management expenses that cannot be carried forward.

**Order of set-off**

One area not addressed directly by the new legislation is the order of set-off of management expenses, in relation to other losses and deficits.

In a trading company, the situation appears quite simple, as management expenses are deducted from total profits, including the trading profit; see **Example 1**.

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**Example 1**

Company A has trading profits £100 and investment income £100, with management expenses £150. The total profits of the company are therefore £50.

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Where there is a trading loss, management expenses would seem to have priority, as the new section 75(1) makes the deduction from total profits mandatory, while setting trading losses against 'profits (of whatever description)', in section 393A, is the subject of a claim. See **Example 2**.

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**Example 2**

Company B has trading losses £100 and investment income £100, with management expenses £150.

The analysis would appear to be that £100 management expenses are set against the investment income and £50 management expenses and £100 trading losses are carried forward.

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With regard to the interaction of brought forward trading losses and management expenses, section 9(3), Taxes Act 1988 says that the total profits comprise the aggregate of profits under each Schedule and Case, with chargeable gains. Trading losses carried forward are mandatorily set off against future profits of the same trade only, which give the Schedule D, Case I result to be included in total profits. Management expenses carried forward are then mandatorily set off against those total profits of the later accounting period. See **Example 3**.

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**Example 3**

Company C has trading profits £100 and investment income £100, with no management expenses of the accounting period. Trading losses brought forward are £50 and management expenses brought forward are £200.

The analysis would appear to be that £50 trading losses are set against the trading profit, reducing it to £50.
Then the management expenses are set against the total remaining profits, £150, and £50 management expenses are carried forward.

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What is the situation with non-trading loan relationship deficits? Section 83(2)(a), Finance Act 1996 allows a claim to be made to set a non-trading loan relationship deficit for a period against 'profits of the company (of whatever description)', on making a claim. Since the relief for management expenses is mandatory, they would again seem to have priority, similar to Example 2. See Example 4.

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Example 4

Company D has trading profits £100 and investment income £100, with non-trading loan relationship deficits £100 and management expenses £150.

The analysis would appear to be that the management expenses are set against the total profits of £200, leaving £50 that can be covered by the non-trading loan relationship deficits on a claim. £50 non-trading loan relationship deficits are the carried forward.

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Where non-trading loan relationship deficits are carried forward, they are set against non-trading profits of the company for the later period and this set-off appears to be mandatory (section 83(3A), Finance Act 1996 uses the word 'shall'). So we have a conflict of two mandatory set-offs against potentially the same income. If there is sufficient trading income in the later accounting period to extinguish the management expenses, the situation is arguably straightforward as the non-trading loan relationship deficits brought forward cannot be used this way. But what if there is only non-trading income? Possibly the best view (partly because the Revenue agrees with this analysis) is that the management expenses are used first. This is because management expenses are deducted 'in computing total profits', whereas non-trading loan relationship deficits brought forward 'shall be set against non-trading profits'. If we equate 'non-trading profits' with 'total profits', then management expenses are deducted in arriving at the profits and non-trading loan relationship deficits are deducted from those profits. See Example 5.

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Example 5

Company E has investment income £200. Non-trading loan relationship deficits brought forward are £50 and management expenses brought forward are £200.

The analysis would appear to be that £200 management expenses are set against the investment income and £50 non-trading loan relationship deficits are carried forward again.

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No doubt, however, alternative views will be expressed and argued for in due course.

Conclusions

This is a welcome new régime for management expenses, and one wonders why it has taken the Revenue
so long to sort it out. It is almost certain to become law, having passed committee stage with only very minor amendments that have no effect on the content of this article.

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