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Section 18 and Schedule 4: carried-forward losses; Section 19: losses: counteraction of avoidance arrangements

Section 18 of and Schedule 4 to the Finance (No.2) Act 2017 (F(No.2)A 2017) introduce changes to the way losses can be carried forward and set against profits in later periods for corporation tax purposes. The provisions address only "revenue" losses: no changes are made to the use of capital losses. The reforms were announced at Budget 2016[1] and were consulted on in summer 2016.[2]

The broad effect of the changes can be stated simply enough:

- First, there is a relaxation of the ways in which carried-forward losses arising from April 2017 onwards (post-April 2017 losses) can be used, both within the loss making company and by way of group relief.
- Secondly, a restriction is imposed on the extent to which profits arising from April 2017 onwards (post-April 2017 profits) can be relieved by carried-forward losses (whenever those losses arose).

[1] HM Treasury, *Budget 2016* (March 2016), HC 901.
[2] HM Treasury and HMRC, *Reforms to corporation tax loss relief: consultation on delivery* (26 May 2016), available at: *https://www.gov.uk/government/consultations/reforms-to-corporation-tax-loss-relief-consultation-on-delivery* [Accessed 9 November 2017].

- Finally, a Targeted Anti-Avoidance Rule is introduced and the existing anti-avoidance rules are extended.

The changes come under the guise of "simplifying and modernising the tax system".[3] However, anyone who has tackled the 145 pages of Schedule 4 F(No.2)A 2017 would be forgiven for questioning whether simplification has been achieved. Particular complexity arises as follows:

- First, the relaxations in the ability of companies to use losses will only apply to post-April 2017 losses. For the most part, the restrictions on the use of losses that accrued under the pre-April 2017 system remain and the old system will run in parallel with the new regime for post-April 2017 losses.
- Secondly, much of the complexity in the old rules was derived from the remnants of the "schedular" system of taxation requiring a separate calculation of profits for each category of taxable activity, together with separate rules dealing with losses from each activity. The Government has resisted calls for wider simplification to sweep away the various different categories of losses in the post-April 2017 regime. The principal categories of "losses" therefore remain: trading losses, UK property losses, overseas property losses, non-trading loan relationship deficits (NTLRDs), which include non-trading derivative contract deficits, non-trading losses on intangible fixed assets, excess management expenses and capital losses.
- Further complication is added because the relaxation on the use of post-April 2017 losses under the new rules is reversed where certain conditions are not met. This means that the existing legislative architecture for "streaming" losses has to be retained for post-April 2017 losses.

Notwithstanding the increased flexibility offered in the use of losses, overall the changes are revenue raising. The increase in the tax burden is borne by larger taxpayers. This is because the new restriction on the use of carried-forward losses will accelerate their tax receipts—as their losses are used more slowly—and in some cases the new restriction will actually increase the total tax paid by businesses over their "life". This is reflected in the Budget 2017 costings which estimated that the changes would increase corporation tax receipts as far ahead as 2021–2022 by £215 million each year.[4]

This note cannot deal in detail with all of the new provisions. What follows is a summary of the main points. The summary does not seek to address the specific provisions that apply to insurance companies, oil and gas companies and companies in the creative sector.

Schedule 4 Part 1: relaxation of the way in which carried-forward losses can be used

Part 1 of Schedule 4 F(No.2)A 2017 provides for the new regime for the use of post-April 2017 losses and makes some consequential changes to the regime for pre-April 2017 losses.

[3] HM Treasury and HMRC, above fn.2, para.1.5.

[4] HM Government, *Spring Budget 2017: policy costings* (March 2017), available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597335/PU2055_Spring_Budget_2017_web_2.pdf* [Accessed 9 November 2017].

Trading losses

A reminder of the existing rules for trading losses helps to set the changes in context. Currently, the default rule is that trading losses are carried forward and automatically set against profits arising in the same company from the same trade in later accounting periods.[5] A claim can be made to set trading losses instead against total profits arising in the loss making period or in the 12 months immediately preceding the loss making period.[6] In the case of losses arising in a period in which the trade ceases, this ability to carry back against total profits is extended to a period of three years immediately preceding the loss making period (terminal loss relief).[7] Finally, losses can be surrendered by way of group relief on a current year basis.[8]

Paragraph 10 of Part 1 of Schedule 4 F(No.2)A 2017 limits the existing automatic carry forward in section 45 of the Corporation Tax Act 2010 (CTA 2010) to pre-April 2017 trading losses. It then modifies the approach for those losses by allowing a period to be skipped when carrying forward those losses. A claim has to be made for this purpose. The effect of a claim is that carried-forward pre-April 2017 losses are not automatically used in priority to others.

Paragraph 11 of Part 1 of Schedule 4 F(No.2)A 2017 introduces new sections 45A to 45H CTA 2010 dealing with the carry forward of post-April 2017 trading losses. Section 45A CTA 2010[9] provides for the new "relaxed" use of carried-forward trading losses: where the section applies trading losses are carried forward automatically but relief is only given if a claim is made. Where a claim is made the loss can be set against total profits. Various conditions must be met for section 45A CTA 2010 to apply including: 1. that the trade did not become small or negligible in the loss making period (or a period between the loss making period and the claim period); and 2. conditions mirroring the existing restrictions on the use of losses in the loss making period (such as the requirement for the trade to be conducted on a commercial basis).

Where the conditions for section 45A CTA 2010 to apply are not met, new section 45B CTA 2010 applies: provided the trade continues, trading losses are carried forward and automatically set against profits from the same trade (subject to claims to skip periods).

In summary, therefore, where the trade does not become small or negligible, post-April 2017 trading losses are carried forward and set against total profits in future periods[10] on a claim being made. Where the trade continues but does become small or negligible, post-April 2017 trading losses are carried forward and set against profits from the same trade in future periods[11] in much the same way as pre-April 2017 losses. Meanwhile the treatment of pre-April 2017 trading losses remains unchanged[12] except for increased flexibility over the later period in which losses are used.

[5] CTA 2010 s.45.
[6] CTA 2010 s.37.
[7] CTA 2010 s.39.
[8] CTA 2010 Pt 5.
[9] CTA 2010 s.45A does not apply to ring fence trades (CTA 2010 s.45A(2)).
[10] CTA 2010 s.45A.
[11] CTA 2010 s.45B.
[12] CTA 2010 s.45.

Other losses

Similar changes are made to the rules which govern the way in which other categories of losses can be carried forward and used to shelter future profits. These changes can be summarised as follows.

The current default rule for NTLRDs is that, subject to claims to use them against other profits in the deficit period or loan relationship profits in the 12 months immediately preceding the deficit period, NTLRDs are carried forward and set against non-trading profits (subject to claims to skip years) under Chapter 16 of Part 5 of the Corporation Tax Act 2009 (CTA 2009).

Part 1 of Schedule 4 F(No.2)A 2017 limits Chapter 16 of Part 5 CTA 2009 to pre-April 2017 NTLRDs[13] and introduces a new Chapter 16A CTA 2009 for post-April 2017 NTLRDs.[14] Within the new Chapter 16A, new section 463G CTA 2009 allows post-April 2017 NTLRDs to be carried forward and (on a claim being made) to be set against total profits, but only where the company's investment business has not become small or negligible in an earlier period. Where the investment business has become small or negligible, post-April 2017 NTLRDs are carried forward and set against non-trading profits (subject to claims to skip years) under new section 463H CTA 2009. Post-April 2017 NTLRDs cannot be carried forward after the company has ceased to be a company with investment business.

Carried-forward losses on intangible fixed assets are already available for use against total profits in later periods, so the only material change made by Part 1 of Schedule 4 F(No.2)A 2017[15] is that no such losses are carried forward after the company has ceased to be a company with investment business.

As regards excess management expenses and losses from a UK property business (which again can already effectively be carried forward against total profits), the material changes made[16] are simply that a claim is now required to use carried-forward amounts against total profits; in the absence of a claim the excesses are carried forward to later periods.

Schedule 4 Part 2: restriction on the reduction of post-April 2017 profits

Part 2 of Schedule 4 F(No.2)A 2017 introduces a new Part 7ZA into CTA 2010. It contains the new restriction on the use of carried-forward losses to reduce post-April 2017 profits.

In general terms, the new restriction is that only 50 per cent of post-April 2017 profits in excess of a "deductions allowance" can be sheltered by carried-forward losses. The restriction applies to the use of both pre- and post-April 2017 losses.

Post-April 2017 profits are calculated after the use of all "in-year reliefs". The "deductions allowance" is £5 million of profits per group or stand-alone company per year. Groups are free to allocate their total £5 million deductions allowances as they like around companies within the group.[17]

[13] F(No.2)A 2017 Sch.4, Pt 1, para.3.
[14] F(No.2)A 2017 Sch.4, Pt 1, para.4.
[15] F(No.2)A 2017 Sch.4, Pt 1, para.5.
[16] F(No.2)A 2017 Sch.4, Pt 1, paras 6 and 13.
[17] CTA 2010 new s.269ZV.

The new 50 per cent restriction is therefore intended to ensure that single companies or groups with annual profits in excess of £5 million pay some level of current year taxation, even where they have significant carried-forward losses. The existing restriction for banking companies on use of carried-forward losses from a pre-April 2015 period continues to apply (the percentage of profits of a banking company available for reduction by such losses having been reduced from 50 per cent to 25 per cent by the Finance Act 2016 for periods after April 2016). The new restriction introduced by F(No.2)A 2017 is modelled on the same principles, but applies to all losses (and all companies). The new provisions are complicated by the need to apply the restriction separately to trading profits and non-trading profits, to cater for the fact that (as described above) in some circumstances carried-forward trading losses and NTLRDs are not available against total profits.

This restriction is imposed in the most convoluted way imaginable. The starting point is new section 269ZB CTA 2010 which provides that deductions for carried-forward trading losses against profits from the same trade (for example, deductions for pre-April 2017 losses and deductions for post-April 2017 losses that do not meet the conditions in section 45A CTA 2010) may not exceed the sum of: 1. 50 per cent of "relevant trading profits"; and 2. the company's trading profits deductions allowance. New section 269ZC CTA 2010 makes similar provision as regards deductions for carried forward NTLRDs against non-trading profits. New section 269ZD CTA 2010 then imposes the restriction on deductions for carried-forward losses against total profits (for example, deductions under new section 45A CTA 2010).

A company is free to specify how its deductions allowance is split between a trading deductions allowance and a non-trading deductions allowance.[18] As mentioned above, the rules apply to profits after the application of "in year reliefs", and a company is free to allocate these to trading profits and non-trading profits (for the purposes of the calculation of the restriction) as it likes.

Finally, where a company ceases to carry on a trade and has carried-forward losses which cannot be relieved in the period in which the trade ceases, the 50 per cent restriction is removed for the last three years during which the trade is carried on.[19]

The new restriction is clearly intended to affect the timing of corporate tax receipts: where significant losses are incurred and the company or group's profits exceed £5 million in any subsequent year, it will take longer to use losses (and tax will be payable in profitable years even where the business is still in an aggregate loss making position over its life to date). Companies and groups with volatile results will pay tax sooner than they might otherwise have done.

This is broadly a timing effect (assuming constant rates of tax!). Some businesses will, however, be exposed to paying tax, over their life, on profits in excess of their actual profits.

This problem is likely to be more acute in some sectors than others.

For example, a property development company which makes significant losses in its early years will pay tax on more than the total profits over the life of the development where the profits from the last three years of trading are insufficient to absorb carried-forward losses.

The position is worse for non-traders that do not benefit from the removal of the restriction in the final three years of business. Non-traders with accrued carried-forward losses will suffer

[18] CTA 2010 new s.269ZC(5) and new s.269ZB(7).
[19] CTA 2010 new s.45F.

tax on more than their actual profits where profits of the final period are not sufficient to absorb unused carried-forward losses.

For example, companies that act as general partners to private equity partnerships will typically make losses in the early years of the fund: the investments will not have been realised and the general partner will be paying fees to the fund manager. In later years, these "corporate GPs" will be allocated profits from the fund partnership. Before the introduction of the 50 per cent restriction, the corporate GP would carry forward its losses from the early years and set them against profits in the later years so that it paid tax on its true economic profit over the life of the fund. That may no longer be the case if the new 50 per cent restriction bites in the later years. The rules have no "grandfathering" provisions to help existing funds, for whom restructuring to mitigate the effects of the new rules may be commercially unpalatable.

Schedule 4 Part 3: group relief for carried-forward losses

Part 3 of Schedule 4 F(No.2)A 2017 introduces a new Part 5A CTA 2010 which provides for group relief for carried-forward losses.

The main provision is new section 188BB CTA 2010 which provides for the surrender of post-April 2017 carried-forward losses which would otherwise be available for use against total profits.

A number of restrictions are then imposed by new sections 188BC to 188BJ CTA 2010. Many of these reflect the corresponding restrictions on current period group relief pursuant to Part 5 CTA 2010. The additional restrictions include: a restriction where investment business has become small or negligible[20]; a requirement for carried-forward losses to be used by the surrendering company in priority to being surrendered by way of group relief[21]; and a prohibition on surrender where the surrendering company has no income producing assets at the end of the surrender period.[22]

New Chapter 3 of Part 5A CTA 2010 prescribes the required relationship between the surrendering and claimant company for carried-forward group relief. For group relief claims which rely on the grouping condition (that is, not consortium claims) and consortium claims involving the surrender of losses to a company by a consortium (a "section 188CB claim"), the relevant condition is required to be met at some point in a period which is common to the relevant accounting period of the claimant and the relevant accounting period of the surrendering company in respect of which the claim is made.[23] In contrast, for consortium claims involving the surrender of losses by a company to a consortium (a "section 188CC claim"), the relevant condition must be met throughout a period which begins in the accounting period of the surrendering company to which the losses are attributable and ends during or after the period which is common to the relevant accounting period of the claimant and the relevant accounting period of the surrendering company in respect of which the claim is made.[24]

[20] CTA 2010 new s.188BD.
[21] CTA 2010 new s.188BE.
[22] CTA 2010 new s.188BF.
[23] CTA 2010 s.188CB(3).
[24] CTA 2010 s.188CC(3).

Section 188CD CTA 2010 prohibits a claim where the claimant itself has unused carried-forward losses thus ensuring that losses are used within a company in priority to group relief.

New Chapter 4 of Part 5A CTA 2010 contains limits on the amounts of losses that can be surrendered under a section 188CB claim. New Chapter 5 of Part 5A CTA 2010 deals in a similar way with amounts that can be surrendered under a section 188CC claim. This note does not review these provisions in detail. They include limitations on the amount of losses that can be claimed by reference to the proportion of the common accounting period for which the relevant condition is fulfilled and provisions to deal with the interaction with the new 50 per cent restriction and other group relief claims.

Schedule 4 Part 9: extension to anti-avoidance

Part 9 of Schedule 4 F(No.2)A 2017 extends the existing anti-avoidance rules in Parts 14 to 14B CTA 2010 (that is, the streaming rules on change of ownership, the "deduction buying" rules and the "loss refreshing" rules) to deal with carried-forward losses.

Loss refreshing rules

The changes start with the loss refreshing rules: paragraph 69 of Part 9 of Schedule 4 F(No.2)A 2017 extends these to apply to carried-forward UK property business losses and carried-forward losses on intangibles. It also ensures that the existing application to carried-forward trading losses and carried-forward NTLRDs extends to post-1 April 2017 losses carried forward.[25]

Change in company ownership

Paragraphs 70 to 91 of Part 9 of Schedule 4 F(No.2)A 2017 then deal with the rules on change in company ownership in Part 14 CTA 2010.[26]

Perhaps most significantly, paragraph 72 of Part 9 of Schedule 4 F(No.2)A 2017 extends the main restriction on the carry forward of trading losses on a change in ownership so that it applies if the "major change" in the nature or conduct of the trade occurs at any point in a five (rather than three) year period in which the change of ownership occurred (starting at up to three years before the change of ownership). The effect is therefore that a major change in the conduct of a trade up to five years after a change of ownership can restrict the availability of losses.

Similar changes are made throughout Part 14 CTA 2010. For example, paragraph 80 of Part 9 of Schedule 4 F(No.2)A 2017 amends Chapter 3 (restriction of relief for companies with investment business) so that the rules apply to a major change in the period of eight years (rather than six years) beginning three years before the change of ownership. In addition, the period over which significant increases in capital are tested is extended to five (rather than three) years after the change of ownership.

Paragraphs 75 to 79 of Part 9 of Schedule 4 F(No.2)A 2017 each introduce a new chapter in Part 14 CTA 2010. Perhaps the most significant are new Chapters 2A and 2C. New Chapter 2A

[25] F(No.2)A 2017 Sch.4, Pt 9, para.69.
[26] F(No.2)A 2017 Sch.4, Pt 9, paras 70–91.

applies where there is a change of ownership and there is (within the five year period described above) a major change in the business of a co-transferred company (or the transferred company, where Chapter 2 does not otherwise apply). New Chapter 2C is a general restriction on group relief for carried-forward losses where there is a change of ownership. The main effect of new Chapter 2C is that group relief for carried-forward losses can only be used to shelter either profits arising five years after the change or profits of a company which was grouped with the surrendering company before the change.

Deduction buying

Finally, paragraph 92 of Part 9 of Schedule 4 F(No.2)A 2017 extends the rules on "deduction buying" in Part 14A CTA 2010 so that, where the conditions for Part 14A to apply are met, the rules apply to the group relief of carried-forward losses (in addition to current period group relief).

Schedule 4 Part 12: commencement

The amendments made by Schedule 4 F(No.2)A 2017 have effect in relation to accounting periods beginning on or after 1 April 2017. A period straddling 1 April 2017 is treated as two separate accounting periods (one ending on 31 March 2017) and amounts are apportioned on a time basis (except where doing so would not be just and reasonable).

A different apportionment rule applies where the corporate interest restriction (introduced by Schedule 5 F(No.2)A 2017) applies. This is to ensure that, where taxable profits are increased due to the interest restriction (which only has effect for post-1 April 2017 periods) that increase is apportioned to the post-1 April 2017 period for the purposes of applying the amended losses rules.

Section 19: losses: counteraction of avoidance arrangements

No matter how many specific provisions it contains to address potential avoidance, no new tax regime is complete without a regime-wide anti-avoidance rule.

Section 19 F(No.2)A 2017 contains the regime-wide Targeted Anti-Avoidance Rule (or TAAR) for the revised regime for corporate losses. It acts to counteract a "loss-related tax advantage",[27] meaning a tax advantage arising as a result of any loss relief rule (including the rules for current period relief, current period group relief and carry-back relief, as well as the new-carry forward rules).

The TAAR applies to arrangements where: 1. one of the main purposes of the arrangements is to obtain a loss-related tax advantage; and 2. it is reasonable to regard the arrangements as circumventing the intended limits of relief under the relevant provisions or otherwise exploiting shortcomings in the relevant provisions. All relevant circumstances are to be taken into account in determining whether 2 is met, "including whether the arrangements include any steps that … are contrived or abnormal, or … lack a genuine commercial purpose".[28]

[27] F(No.2)A 2017 s.19(1).
[28] F(No.2)A 2017 s.19(6).

Given the complexity of the loss relief provisions, taxpayers may find it difficult to determine the "intended limits of relief".[29] However HMRC have at least confirmed in draft guidance[30] that capital allowances claims and claims for losses to be carried over to subsequent periods are not caught simply because they create an advantageous result for the company.

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[29] F(No.2)A 2017 s.19(5).
[30] HMRC, Guidance, *Reform to Corporation Tax loss relief: draft guidance* (31 July 2017), available at: *https://www.gov.uk/government/publications/reform-to-corporation-tax-loss-relief-draft-guidance* [Accessed 23 November 2017].

Anti-avoidance; Carry-forward reliefs; Corporation tax; Group relief; Losses

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