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PRACTICE NOTE

PN 78-99

Date:

Application Of The 15% Company Rate

Introduction

Practice Note PN73/99 issued by the Income Tax Division on 16th February 1999 set out details of the proposed new 15% tax band for companies which was announced by the Treasury Minister in his Budget speech. It was also announced that a consultation period would be provided to enable the industry to comment on the proposals. This PN now formalises the operation of the new rate band following that period of consultation and the approval by Tynwald on 18th May 1999 of the Income Tax (Temporary Taxation)(Lower Tax Rate)(Companies) Order 1999, (hereinafter referred to as 'the Order'). A copy of the Order is attached.

The Effect Of The Order

The Order extends the standard rate of 15% to the first £100,000 of an eligible trading company's taxable income (hereinafter referred to as the 15% band) with effect from the 1999/2000 year of assessment. The 15% band will apply to any 1999/2000 assessment, irrespective of the basis of assessment.

A Qualifying Company

A company is a qualifying company for the purposes of the 15% band where the company derives the whole of its trading profits from a trade which is carried on in the Island and the company is either:-

Formed and registered under the Companies Act 1931(c); or registered under Part XI of that Act; or a body corporate in respect of which a certificate has been issued under paragraph 3(4)(a) of Schedule 3A to the Insurance Act 1986(d); or a body corporate in respect of which a certificate has been issued under Section 4(2) of the Companies (Transfer of Domicile) Act 1998(e)

A company which is either resident or non-resident for tax purposes will come within the above definitions, but branch operations are excluded.

Investment Companies

An investment company within the meaning given in Section 120 of The Income Tax Act 1970 is not a qualifying company. Section 120 defines an investment company as;

"an association incorporated in the Isle of Man, or a body corporate resident though not incorporated in the Isle of Man, the sole or principal object of business of which is the investment of money, and which does not bona fide engage to a substantial extent in any business, industrial or commercial undertaking other than the investment of money, and for the purpose of this definition the expression "the investment of money" shall include the sale and purchase of investments or securities or the under-writing of investments."

Interaction Of The 15% Band With The Commencement And Cessation Provisions

Where a qualifying company is in the opening or closing years of trade the 15% band is reduced to an amount determined by the formula $\text{£}100,000/12 \times 'T'$ 'T' being the number of complete months (part months are ignored) in the relevant income tax year during which the company was carrying on its trade in the Island. A month for these purposes is a period beginning on the 6th day of any month and ending on the 5th day of the following month.

Example

Example A company commenced trading on 15th September 1999. 'T' is 6, being the 6 months beginning 6th October 1999 and ending 5th April 2000. The part month 15th September to 5th October 1999 is ignored.

$$\text{£}100,000/12 \times 6 = \text{£}50,000.$$

The first £50,000 of the company's taxable income in its first part year of trading will therefore qualify for the 15% band.

Restriction of the 15% Band Between Associated Companies Definitions:

"Associated Company" is defined within the Order as -

"A company is to be treated as an associated company of another if, at any time within the year of assessment, one of the two has control of the other or both are under the control of the same person or persons."

"Control" is defined in Section 119A of the Income Tax Act 1970 as - "the power of a person to secure -

1. by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or
2. by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate, that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person....."

In order to alleviate the avoidance of a tax liability by disaggregation of activities through associated companies the £100,000 15% band is divided between all active associated

companies which are qualifying companies. Where in any income tax year, a company has one or more associated companies, there are two alternative methods of allocation of the £100,000 taxable income for the 15% band. These are contained in Articles 5(1) and 5(2) of the Order.

Note :

An associated company is counted even if it is associated for only part of that year, and two or more associated companies are counted even if they are associated for different parts of the year. An associated company is counted even if its taxable income is 'nil' by virtue of a loss having been made in the year. In identifying associated companies, it is the companies which fall within the definition in the year of assessment to which the claim relates, not those which were associated in the relevant accounting period or income year.

Allocation Under Article 5(1) Of The Order

Article 5(1) of the Order restricts the £100,000 between associated companies, whether associated for the full year (or in a reduced amount where a company is in the opening or closing years of trading) by the formula

$$A / N + 1$$

where -

A is the £100,000 or the reduced amount in opening or closing years,

N is the number of companies which are associated with company 1.

Any unutilised 15% band allocated to a company under Article 5(1) cannot be transferred to another associated company. Any such re-allocation of the 15% band may only be made by electing to allocate the 15% band between associated companies under Article 5(2) of the Order.

Example 1

Companies 'A', 'B', 'C' and 'D' are associated throughout 1999/2000

Each are entitled to a 15% band of :-

$$£100,000 / 3 + 1 = £25,000$$

Example 2.

Companies 'A' and 'B' are associated throughout 1999/2000. 'A' has taxable income of £120,000 and 'B' has taxable income of £40,000. 'C' was associated from 6th April 1999 until it ceased trading on 5th July 1999 with taxable income in the final part year of £5,000. 'D' was associated from commencing to trade on 1st December 1999 with taxable income of £5,000.

'A' Ltd $£100,000 / 3 + 1 = £25,000$ of the 15% band allocated

'B' Ltd $\text{£}100,000 / 3 + 1 = 25,000$ of the 15% band allocated

'C' Ltd $\text{£}100,000 / 3 + 1 \times T(3) / 12 = \text{£}6,250$ of the 15% band allocated

'D' Ltd $\text{£}100,000 / 3 + 1 \times T(4) / 12 = \text{£}8,334$ of the 15% band allocated

It can be seen in this example that of the total taxable income of the companies of $\text{£}170,000$, only $\text{£}64,584$ qualifies for the 15% band.

In addition, in considering the taxable income the Article 5(1) restriction has a further effect.

'A' is charged on $\text{£}25,000$ of its taxable income at 15% and $\text{£}95,000$ at 20%

'B' is charged on $\text{£}25,000$ of its taxable income at 15% and $\text{£}15,000$ at 20%

'C' is charged on its $\text{£}5,000$ taxable income at 15%

'D' is charged on its $\text{£}5,000$ taxable income at 15%

'C' therefore has $\text{£}1,250$ of its 15% band of $\text{£}6,250$ unutilised, and 'D' has $\text{£}3,334$ of its 15% band of $\text{£}8,334$ unutilised.

Allocation Under Article 5(2) Of The Order

Article 5(2) permits any associated companies to make a written claim to allocate the $\text{£}100,000$ 15% band between them in such proportions as they elect. Any election should

detail all companies which are associated in the year of assessment to which the claim relates; and

detail those companies which are surrendering or disclaiming the whole or part of their allocation of the 15% band; and

detail the company or companies which are claiming the whole or any part of the 15% band;

Any claim must be made in writing and be made within two years of the end of the year of assessment to which the claim relates. Using the above examples therefore:

Example 1

Company 'A' could elect to disclaim/surrender all or part of its $\text{£}25,000$ proportion of the 15% band in favour of 'B' who would make the corresponding claim. The claim could be made at any time on or before the 5th April 2002.

Example 2

Companies 'B', 'C' and 'D' could elect to claim an allocation of the 15% band to charge all their taxable income at 15% with 'A' claiming the balance of $\text{£}14,584$. Equally, companies

'B', 'C' and 'D' could elect to disclaim any allocation of the 15% band in favour of 'A' claiming the whole 15% band.

It can therefore be seen from the above that where there are associated companies, it is beneficial for an election to be made under Article 5(2) of the Order when the relevant accounts and computations are submitted. Any election under Article 5(2) will require the consent of all companies which are qualifying associated companies in the relevant year of assessment. Should any such company not provide its written consent when the election is made, then the Article 5(2) election may be jeopardised. An election under Article 5(2) rather than 5(1) is also advantageous to associated companies where, for example, a new associated company begins to trade in a year. As the allocation is linked to the companies which are associated in the year of assessment, the new company is counted as an associated company and allocated a proportion of the 15% band, albeit that it may have no income tax liability in the year

Example

An existing group of three companies whose year ends are 31st December 1998, therefore profits assessable 1999/2000, set up a new company which commences to trade on 1st July 1999. In considering the allocation of the 15% band for 1999/2000, the new company counts as an associated company for that year of assessment. Whilst it may have made losses in the first part year, unless the companies elect to allocate the 15% band to the original three companies by way of an election under Article 5(2), the new company will be allocated part of the 15% band under Article 5(1), notwithstanding that it may have no income tax liability in the year.

Associated companies which may be disregarded in any election

The Order applies the 15% band to trading companies only and the fact that investment companies do not therefore qualify has been highlighted earlier in this PN.

The following companies may also be disregarded

A dormant company

An asset holding company

A nominee company

A company which is intended to be a trading company which has not commenced activities in the year of assessment

An exempt company

An international company (unless the company has a liability greater than the minimum tax charge and elects to qualify for the 15% band)

Notification Of Associated Companies

In order to avoid delays in raising assessments, agents are requested to either: a) confirm that there are no qualifying associated companies, or b) include the details of any qualifying associated companies and provide the required election and allocation under Article 5(1) or 5(2) of the Order when submitting the accounts and computations. A separate letter confirming the above is requested in appropriate cases should accounts and computations already have been submitted at the time of issue of this Practice Note. Failure to provide these may result in the Division allocating the 15% band under Article 5(1) of the Order which undoubtedly will lead to correspondence and potentially subsequent revisions to the assessments in due course once a belated election has been made and agreed.

Companies Subject To Existing Concessions

Where a company is a qualifying company, and by virtue of its activities is already subject to any concessional practice such as fund managers, international loans, or exempt insurance companies which have elected to be partially exempt, then, notwithstanding the existing concessional treatment, the company will qualify for the 15% band. Such companies will equally therefore be associated companies for the purposes of the 15% band.

Example - Fund Manager:

Fund manager profits £300,000

Less: 75% deduction £225,000

£ 75,000

Add: Bank interest £ 30,000

Taxable Income £105,000

£100,000 will be liable at 15%

£5,000 will be liable at 20%

Order Of Offset - Taxed Foreign Income Sources

Where a company has taxed foreign income sources, the 15% band will be allocated against untaxed income first, i.e. in the most favourable manner to the company.

Example

A company has trading profits of £130,000 of which £40,000 has suffered foreign tax at 20%.

The £90,000 untaxed income will be taxed at 15%, double tax relief will be granted on £10,000 at 15% and £30,000 at 20%

Other Specific Case Scenarios And Their Treatment Under The Order

* A holding company which is an "associated company" will not qualify for the 15% band unless it is carrying on a separate and substantial trading activity. For it to be substantial at least 75% of its total income must arise from that trading activity. * The Division will continue its current practice of accepting a company as carrying on a trading activity where it is in receipt of significant income from the letting of commercial property. For this purpose a commercial property will include any property which is 'rated' as a commercial property and from which trading activities are undertaken. Companies whose income falls to be classified as trading income under PN51/94, 'Assessment of Income From Land and Property' will also qualify for the 15% band. Evidence may be called for to substantiate that the business both needs to be organised and is being organised in the same manner as a trade. * Where a company is a qualifying company, the proposed restriction to exclude any investment income from the 15% band where that income exceeds £10,000 which featured in PN73/99 has not been introduced. The 15% band will apply to the whole of the taxable income of the company, which for this purpose will be after capital allowances, distributions and any loss/group relief. * The fact that an investment company has an incidental trading activity will not be sufficient to classify the company as a qualifying company for the 15% band.

Article 6 Of The Order - Assessment Of Undistributed Profit

It may be possible for an individual to avoid a personal tax liability by the accumulation of profits within a company. In the exceptional case that it is believed that the profits are being accumulated to bring about a reduction in the tax liability of an individual(s), the Assessor under Article 6 of the Order is permitted to apply the provisions of Sections 12 and 13 of the Income Tax Act 1970 to deem that in effect a distribution of income has taken place. The subsequent actual distribution when made in due course will then be treated as being of a capital not an income nature.