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79.1 Introduction

At first sight there should be no need for special legislation to deal with investment companies, and also almost no need for anyone to create such a company. An individual who wishes to hold investments is usually much better advised to hold them directly rather than through a company. Although the corporation tax rate may be lower than the income tax rate, money extracted as dividends in excess of £2,000 annually will be subject to a further layer of tax (see above at §61.3.1), and the close company rules designed to penalise loans may apply. In the unlikely event that money is extracted by way of capital gain, as by the sale of shares, there will be the further problem of a double charge on capital gains already realised by the company. Without special reliefs, the addition of investment intermediaries could mean triple or quadruple taxation of capital gains.

However, this is to see things simply in terms of the individual wealth holder. Investment companies are important parts of the investment market. Some, such as approved investment trusts, open-ended investment companies and approved unit trusts (which are taxed as if they were companies), receive special reliefs from some or all of these consequences. They will not be close companies, and are usually exempt from corporation tax on their profits and gains. This chapter focuses on the special expenses rule for all investment companies.

79.2 Management Companies with Investment Business—Deduction of Management Expenses

CTA 2009, Part 16 (ex TA 1988, section 75) allows companies with investment business to deduct certain expenses of management from their profits in addition to those already deductible, eg under CTA 2009, Parts 3 or 4. Pursuant to section 1218B, a 'company with investment business' means a company whose business consists wholly or partly of making

investments (and is not a credit union).[32] The reason why Part 16 is needed lies in the schedular system. Most revenue expenses incurred in earning trading profits or income from property are deductible from gross receipts in arriving at the net income assessable, under the rules now in CTA 2009, Parts 3 and 4. However, relief was not normally given for expenses incurred in earning investment income, such as company dividends and interest. TA 1988, section 75 was first introduced in 1915 in response to increased taxation during the First World War; it was substantially amended by FA 2004 which added section 75A and a new section 75.[33] The rules widened the situations in which expenses may be claimed, and made the timing of the deduction depend on accounting principles and not when the payment is made.

The relief to a 'company with investment business' applies not only to companies whose business consists wholly of making investments, but also to those whose business partly so consists, eg companies which have a trade of their own but also hold shares in subsidiaries. The definition of 'investment company' in TA 1988, section 130 is still there after the Rewrite, as it has a role to play in other rules.[34] In *IRC v Tyre Investment Trust Ltd*,[35] the phrase 'the making of investments' was held to mean 'investing'. It was not necessary for an investment company to buy and sell investments regularly, provided it takes some active interest in the investments which it has made. The asset must be held in order to produce a profitable return and not be merely incidental to some other activity; for this reason a property management company might well not be an investment company.[36] A holding company formed to hold shares in subsidiary companies can be an investment company and can be a company with investment business.[37] The effect of the 2004 change may be seen when considering a trading company deriving income from the investment of large amounts of surplus cash. It will not be an 'investment company' unless it can establish that the main part of its business consists in the making of investments, and the principal part of its income is derived from it. It will, however, be a company with an investment business, and so come within this regime as from 2004.

79.2.1 Qualifying Expenses of Management

The term 'expenses of management' was not defined by TA 1988, section 75 and has been said to be 'insusceptible of precise definition'.[38] Nevertheless, CTA 2009, section 1219 makes an attempt, describing such expenses as in respect of so much of the company's investment business as consists of making investments that are not held for an

[32] CTA 2009, s 1218B, ex TA 1988, s 130.

[33] FA 1915, s 14; later ITA 1918, s 33. On FA 2004, ss 38–46, see Inland Revenue Notes to Clauses 38 *et seq*.

[34] The Revenue Notes, para 26, suggests TA 1988, s 573 (now in CTA 2010, ss 69–73) and the transitional rules in ss 42 and 43.

[35] (1924) 12 TC 646—where the effect of the decision was to bring the company within the charge to Excess Profits Duty.

[36] *100 Palace Gardens Terrace v Winter* [1995] STC (SCD) 126, 129f; distinguished on the facts in *Cook v Medway Housing Society Ltd* [1997] STC 90.

[37] In *IRC v Tyre Investment Trust Ltd* (1924) 12 TC 646, the company was formed to acquire shares in two companies and sell them on. More recently, in *Dawson Group plc v Revenue & Customs Commissioners* [2010] STC 1906, [2010] EWHC 1061 (Ch), Mann J held that a company was an investment company and that certain expenses were not deductible as they were not expenses of management.

[38] *Sun Life Assurance Society v Davidson* [1958] AC 184, 196; 37 TC 330, 354, *per* Viscount Simonds.

unallowable purpose. Capital expenditure is not deductible.[39] These will include staff costs, indirect costs, including repairs to equipment, legal and other professional fees,[40] and property maintenance costs, including rents, rates, maintenance and repairs of premises occupied for business purposes. Sums paid to purchase investments are not management expenses since they are part of the costs of buying investments, not managing them. However, it does not follow that only expenses incurred in the function and process of management may qualify. Relief is available for expenditure incurred in evaluating an investment, such as the legal costs of investigating title, as well as for expenditure on an abortive investment. Judges have indicated that a broad view may be taken of what is an (allowable) expense of investigation as opposed to a (non-allowable) expense of acquisition.[41] In an ideal world one might think that an expense was either an expense of management allowable under this rule, or an expense allowable for capital gains under TCGA 1992 rules. The pre-2004 version of section 75 expressly included commissions;[42] today the matter is left to general principles.

Among the items that will not qualify are capital expenditure, entertainment expenditure, other specifically barred payments, such as bribes and losses on the disposal of investments.[43] In addition, the expense must not be in respect of an investment held for an unallowable purpose, a phrase defined as a purpose which is not a business or commercial purpose of the company, or for the purpose of activities which are outside the charge to corporation tax.[44] Following Revenue guidance, one may say that 'unallowable purposes' therefore covers social or recreational purposes. The insistence that the investment be within the charge to corporation tax means that an investment held by a non-resident company with a UK PE will qualify if the management is part of the activities of the PE of a company, but not otherwise. Expenses of a members' club will not qualify since the club is outside the charge to tax by reason of mutuality.[45]

These rules now have their own anti-avoidance provision. Expenses are excluded if the main purpose (or one of the main purposes) of incurring the expense or of surrounding arrangements is to obtain a tax advantage.[46] Where both this rule and that on manufactured payments apply, this rule has precedence.[47]

[39] CTA 2009, s 1219(3), ex TA 1988, s 75(3) added to reverse the Court of Appeal decision in *Camas v Atkinson* [2004] STC 860. Draft Guidance on these changes, and in particular the exclusion of capital expenditure, is discussed in a Revenue Guidance Note, 15 June 2004, [2004] *Simon's Tax Intelligence* 1472. In *Centrica Overseas Holdings Ltd v HMRC* [2020] UKFTT 197 (TC), the FTT held that expenditure incurred by an investment company related to the sale of the businesses of a subsidiary did not qualify as expenses of management within CTA 2009, s 1219 because the decision was taken by its parent company.

[40] *Holdings Ltd v IRC* [1997] STC (SCD) 144.

[41] Carnwath LJ in *Camas v Atkinson*, above, para 32.

[42] TA 1988, s 75, but not everything called a commission qualifies (see *Hoechst Finance Ltd v Gumbrell* [1983] STC 150, (1983) 56 TC 594).

[43] Unless CTA 2010, ss 68–71, ex TA 1988, s 573 applies—certain losses on the disposal of shares in unquoted trading companies.

[44] CTA 2009, s 1220, ex TA 1988, s 75(3) and (5). These words are becoming common, see eg the loan relationships legislation in chapter 5, above.

[45] Revenue Notes to Clauses 39 *et seq*, paras 14–16.

[46] CTA 2009, s 1220(2)–(5), ex TA 1988, s 75, as amended by FA 2007, s 28, for accounting periods beginning after 19 June 2007.

[47] Ie CTA 2010, s 799, ex TA 1988, Sch 23A, para 7A.

79.2.1.1 Dual Purpose

There is no requirement that expenses must be 'wholly and exclusively' incurred for the purposes of the company's business. Apportionment of expenditure is therefore possible. In particular, if expenditure is excessive, only amounts reasonably incurred will qualify as expenses of management.[48]

79.2.1.2 Relief

Relief is given by deducting expenses of management first from income not otherwise charged to tax as held in the course of the company's investment activities.[49] The balance of expenses remaining is then deducted from other income and chargeable gains of the company. Expenditure still unrelieved may be carried forward, without time limit, against future income, from whatever source, of the company,[50] or it may be relieved by way of group relief.[51] Excess management expenses, unlike trading losses, cannot be carried back to previous accounting periods.

Since 2004 the expense must be 'referable to an accounting period' as opposed to the earlier 'disbursed'. The rules for this are set out in sections 1224–1227, the basic one being when an expense is debited in the company's accounts in accordance with GAAP.[52] Because this means that an expense may be allowed before it is paid, the rules provide for a charge to tax to arise where sums have been credited in the accounts to reverse a previous deduction, eg section 1228.

Restrictions are imposed on the carry-forward of unused expenses where there has been a change in the ownership of a company with an investment business. In addition to the usual references to increases in the scale of the company's activities or revival from quiescence, the rules refer to a 'significant increase' in the amount of the company's capital. There is a 'significant increase' in the amount of an investment company's capital if, in the three years after the change of ownership, the company's capital is either at least double, or greater by £1 million than, the amount of capital before the change.[53] The rules also aim to prevent avoidance by the manipulation of capital at or around the time of the change of ownership.

79.2.2 Investment Dealing Companies

If the company crosses the line to become an investment dealing company, its profits will be computed under the trading rules in CTA 2009, Part 3. Dividends received are treated as arising under its trade.

[48] *LG Berry Investment Ltd v Attwooll* [1964] 2 All ER 126, (1964) 41 TC 547; see also *Fragmap Developments Ltd v Cooper* (1967) 44 TC 366.
[49] CTA 2009, s 1219–1222, ex TA 1988, s 75(6).
[50] CTA 2009, s 1223, ex TA 1988, ss 75(8) and (9).
[51] CTA 2010, ss 99(1)(f), (4), 103 and 105(1)–(4), ex TA 1988, s 403(4), (5).
[52] CTA 2009, s 1225, ex TA 1988, s 75A(2).
[53] CTA 2010, s 677 *et seq*, and in particular s 682, ex TA 1988, s 768B and Sch 28A, Pt I, added in 1995 and updated by FA 2004, Sch 6.

79.3 Insurance Policies

Life assurance presents the UK tax system with various problems. First, the funds held by insurance companies are huge. Secondly, those funds are held for a variety of purposes—of which some are long-term, known as 'life business', eg pensions, annuities and life assurance, while others are short-term, known as 'general business', eg motor, accident and property. Thirdly, some of the companies are 'mutual', ie all the profits accrue to the members of the company (ie the policyholders), as opposed to 'proprietary', where profits are shared between the policyholder members and the owners of the company (the shareholders). Lastly, while the principles of taxation of these companies were originally worked out on the basis of established principles, recent years have seen ever more precise tranches of legislation to secure for the UK a proper share of the profits of an increasingly international business.

The UK tax system accords special treatment to the life insurance industry, but these rules are beyond the scope of this volume. However, it should be noted that the special income tax and CGT rules applicable to life insurance policies have been targeted by tax avoidance schemes. In *Drummond v Revenue & Customs Commissioners*,[54] the taxpayer (D) carried out a CGT loss avoidance scheme. D had bought a second-hand life policy in 2001 for £1.962 million. He then surrendered the policy and obtained its surrender value of £1.75 million (based on the premiums paid); the surrender cost him £210,000. He claimed, invoking TCGA 1992, section 37, that in calculating his gain he could exclude the £1.75 million of surrender value from the proceeds of sale because this was liable to the special rules for income tax in TA 1988, section 541. This would leave him with the large loss now claimed. Today this would be countered by TCGA 1992, section 16A, added in 2007. The Court of Appeal held that this was not a correct application of section 37. Rimer LJ was not going to be party to any 'black letter literalism' (paragraph 23); the purpose of these rules was to avoid double taxation and not to avoid tax altogether.

79.4 Unit Trusts, Open-ended Investment Companies, Investment Trusts and Other Intermediaries

Unit trusts, open-ended investment companies (OEICs) and investment trusts operate in the same sector of the market; they provide a form of pooled investment. The taxation of these intermediaries is not covered in this volume. Rules[55] governing personal portfolio bonds were introduced to reverse the decision of the House of Lords in *IRC v Willoughby*.[56] In that case, the House of Lords held that a UK resident who had purchased a single premium personal portfolio bond at a time when he was a non-resident of the UK was not taxable on the income arising on the bond until its maturity. The rules reversing that result apply to the gain deemed to accrue on such bonds on an annual basis, save for the final

[54] [2009] EWCA Civ 608, [2009] STC 2206.
[55] SI 1999/1029, made under ex TA 1988, s 553C. For useful guidance, see Redston (1999) 143 *Taxation* 114.
[56] [1997] STC 995.

year, when the actual proceeds are used.[57] The rules adapt the life policy chargeable event rules described above.[58] These have been rewritten as primary legislation for income tax by ITTOIA 2005.[59] Other regimes govern products offered by friendly societies,[60] insurance companies,[61] offshore income gains,[62] real estate investment trusts (REITS)[63] and authorised investment funds.[64]

57 SI 1999/1029, reg 5.

58 *Ibid*, reg 6.

59 ITTOIA 2005, Pt 4, Ch 9, ss 475 and 515–526.

60 FA 1995, s 54, Sch 10. Lower figures applied to earlier years; see also TA 1988, s 460(2) (not rewritten).

61 A company with insurance business and other investment management business may find itself using TA 1988, section 76 for its insurance business and CTA 2009, section 1218 (ex TA 1988, section 75) for its other business.

62 Offshore Funds (Tax) Regulations 2009 SI 2009/3001 as amended by SI 2011/1211, ex TA 1988, ss 757–764, Schs 27, 28, originally FA 1984, ss 92–100.

63 CTA 2010, Part 12, ss 518–609, ex FA 2006, Pt 4, ss 103–145.

64 HMRC BN 34, March 2008.