

## **Connected companies and loan relationships (Lecture B1249 – 15.47 minutes)**

There are several special rules that apply where there is a loan relationship between connected companies.

A loan relationship must be measured for tax purposes on an amortised cost basis, irrespective of the accounting treatment adopted. A check should be made to see if the loan has been fair valued in the accounts and ask for figures on an amortised cost basis if so – it may not be obvious from the draft accounts.

Generally there is no deduction for releasing, impairing or writing off a receivable from a connected person (s354), unless:

1. The borrower is in insolvency procedure (s.357); or
2. There is a debt for equity swap which creates the connection (s356).

The borrower is not generally taxed on the credit to P&L on release of the debt (s358).

Watch for the sale of connected party impaired debt to 3rd party at a loss – no deduction is allowed for the loss on disposal.

If a connected party debt is sold to a third party for less than its carrying value, the loss on de-recognition is not a deductible LR debit (s352).

Subsequent impairment reversal or write back is not a taxable LR credit (s360).

Exchange gains and losses on connected party loans are not restricted (s354(3)) and follow the normal taxation rules.

### *Releasing a debt*

Releasing a debt must be a formal procedure using a deed of waiver, properly witnessed.

The lender's directors must consider their statutory duty to act in best interests of the members (but having regard for other stakeholders) before agreeing to the waiver (s172 CA 2006).

There should be a Board meeting minute documenting the decision-making process and reasoning.

### *Example 1*

A parent company lent £10 million to a subsidiary 3 years ago, charging a market rate of interest (currently 5%). In the year ended 31 December 2020, the subsidiary's financial situation has deteriorated significantly because of the effects of Covid-19.

It has failed to pay the interest due on the debt in 2020 of £500,000 and the parent has serious doubts that the subsidiary will be able to repay the loan.

As a result, after taking legal advice, and after concluding that the subsidiary can only continue trading if the parent decides to waive the outstanding interest and the principal sum, the directors sign a deed of waiver on 30 December 2020.

## *Analysis*

### Parent:

- Interest receivable of £500,000 in 2020 is a taxable LR credit;
- The write off of the interest receivable is not a deductible LR debit;
- The write off of the principal sum (£50 million) is not a deductible LR debit.

### Subsidiary:

- The interest expense of £500,000 in 2020 is a deductible debit (subject to any restrictions such as CIR, etc.);
- The release of the liabilities to pay the interest and the principal sum which are credited in the P&L are not taxable LR credits.

## *Other possible scenarios*

If the parent sold the debt to a third party for £1, s352 prevents it from claiming an allowable LR debit for the loss on disposal it would book of £50,499,999 (principal plus accrued interest minus £1 received).

Assume the parent sold the subsidiary in (say) June 2020 to a third party:

- If it writes off the accrued interest of £250,000 and the principal sum of £50 million in the year ended 31 December 2020, the debits are still not deductible (s355);
- If it releases the amounts in the year ended 31 December 2021 (and this in accordance with GAAP), the write-offs will be deductible LR debits as the two companies are not connected at any point in this period.

If the subsidiary is in insolvent administration, insolvent liquidation, administrative receivership, provisional liquidation (or foreign equivalents) when the loan and interest are impaired or released, the debit to P&L will be allowable for LR purposes (s357), but not amounts accruing before one of these events.

## *Example 2*

A Ltd borrows £400,000 from a third party lender.

Due to Covid-19, A Ltd has cash flow difficulties and the lender agrees to discharge 50% of the debt in exchange for 1,000 ordinary shares in A Ltd, with an agreed value of £130,000.

After the share issue, A Ltd has 1,600 shares in issue.

Although the lender and A Ltd are now connected (the lender owns 62.5%), this is only as a result of the debt to equity swap.

The £70,000 loss on derecognising the loan will be an allowable LR debit for the lender (s356).

A Ltd's gain on derecognition of the loan is not taxable (s358).

Any future impairment would not be deductible as the parties are now connected.

*Loans to connected persons granted in accounting periods prior to 1 January 2016*

'Amortised cost' for tax purposes used to be defined as booking the loan initially at the amount lent (net of any transaction costs).

It is then be amortised (if necessary) to the amount payable on redemption.

If the loan has been amortised in the accounts, this needs adjustment to ensure the CT600 and tax computation reflects the tax definition, for both lenders and borrowers.

For loan granted in periods beginning 1 January 2016, the definition of amortised cost follows the accounting definition removing this problem.

*Example*

A controlling shareholder lent a UK company £1,000,000 on 1 April 2015, interest free and repayable on 31 March 2025. The company could have borrowed at a market rate of 6%

There were no issue costs.

The loan has been recorded in accordance with FRS 102/IFRS as set out in the table below.

Explain the adjustments needed when computing the corporation tax liability of the company each period.

<b>Year ended</b>	<b>Bal B/fwd</b>	<b>Accounts Interest 6%</b>	<b>Amortised cost c/fwd</b>
31-Mar-16	558,395	33,504	591,899
31-Mar-17	591,899	35,514	627,413
31-Mar-18	627,413	37,645	665,058
31-Mar-19	665,058	39,903	704,961
31-Mar-20	704,961	42,298	747,259
31-Mar-21	747,259	44,836	792,095
31-Mar-22	792,095	47,526	839,621
31-Mar-23	839,621	50,377	889,998
31-Mar-24	889,998	53,399	943,397
31-Mar-25	943,397	56,603	1,000,000

For tax purposes, the amortised cost is the amount lent of £1m. As the amount repayable is £1m, for tax purposes it is treated as a no interest loan.

All of the accounting interest expense booked for the loan must be disallowed each period.

*Contributed by Malcolm Greenbaum*