

Loan relationships – Non-GAAP accounting (Lecture B1270 – 14.06 minutes)

Introduction

S.308 CTA 2009 states that the amounts to be brought into account are credits and debits in profit or loss which are computed **in accordance with generally accepted accounting practice (GAAP)**.

This is then defined as UK GAAP or UK-adopted IFRS (EU-IAS for periods beginning before 1 January 2021).

Accounts prepared using other GAAP such as US GAAP (unless identical to UK GAAP) are not a suitable basis for UK tax purposes (not just loan relationships, but other areas as well when computing taxable trading profits, for example).

Adjustments may be required for tax purposes where:

1. The accounts are prepared under a different GAAP (e.g. US GAAP), or
2. UK GAAP or UK-IFRS was used but GAAP has not been followed in all respects (perhaps due to materiality).

Example – treatment not in accordance with UK GAAP/IFRS

XYZ Limited raised £100 million on 3 January 2019 by issuing 5% bonds with interest payable half yearly on 30 June and 31 December each year.

The bonds will be redeemed on 31 December 2023. The company incurred fees of £4 million in connection with the issue which it has charged to profit and loss account on the basis that it is immaterial, even though FRS 102 (and IFRS) normally require issue costs to be deducted from the gross proceeds.

It also charges the interest payable for each year of £5 million to profit and loss account each period.

Calculate any adjustments to profit that will be required for the period the bonds are in issue.

Analysis

The issue costs have not been accounted for in accordance with UK GAAP. They should be deducted from the liability of £100 million for the funds raised and recognised in profit and loss by computing an effective rate of interest for each half year period.

Time					Cash
					flow
0	03/01/2019	Proceeds net of issue costs			96.0
1	30/06/2019	Interest			-2.5
2	31/12/2019	Interest			-2.5
3	30/06/2020	Interest			-2.5
4	31/12/2020	Interest			-2.5
5	30/06/2021	Interest			-2.5
6	31/12/2021	Interest			-2.5
7	30/06/2022	Interest			-2.5
8	31/12/2022	Interest			-2.5
9	30/06/2023	Interest			-2.5
10	31/12/2023	Interest plus redemption			-102.5
		Half yearly effective rate			2.97%
Half year ended	Balance b/fwd	Interest 2.97%	Cash flow	Balance c/fwd	
	-	-	96.0	96.000	
30/06/2019	96.0	2.849	-2.5	96.349	
31/12/2019	96.3	2.860	-2.5	96.709	
30/06/2020	96.7	2.870	-2.5	97.079	
31/12/2020	97.1	2.881	-2.5	97.46	
30/06/2021	97.5	2.893	-2.5	97.853	
31/12/2021	97.9	2.904	-2.5	98.257	
30/06/2022	98.3	2.916	-2.5	98.673	
31/12/2022	98.7	2.929	-2.5	99.102	
30/06/2023	99.1	2.942	-2.5	99.544	
31/12/2023	99.5	2.956	-102.5	0	

Adjustments required

Accounting period	Debits in P&L	Debits required by GAAP	Tax disallowance/ (deduction) required
2019	(4 + 5) £9m	£5.709m	3.291m
2020	£5m	£5.751m	(0.751m)
2021	£5m	£5.797m	(0.797m)
2022	£5m	£5.845m	(0.845m)
2023	£5m	£5.898m	(0.898m)
Total	£29m	£29.000m	£0.000m

Deferred tax needed

The above example creates a timing difference between tax profits and accounting profits.

A deferred tax asset will be needed in the 2019 financial statements as follows:

– 2020 reversal: £0.751m x 17.5%	£0.131m
– 2021 reversal: £0.797m x 17%	£0.135m
– 2022 reversal: £0.845m x 17%	£0.144m
– 2023 reversal: £0.898m x 17%	<u>£0.153m</u>
	<u>£0.563m</u>

This created an unusual effective rate in 2019 but will create effective rates equal to the statutory rate in the later years (or would have done had the 17% intended rate of corporation tax not been repealed).

Accounts prepared in accordance with GAAP of other countries

A UK branch of a foreign company will need to prepare its tax computations on the basis that it prepared financial statements under UK GAAP (or UK-IFRS).

The financial statements it files will be those prepared for its head-office reporting purposes and will not necessarily be prepared in accordance with UK GAAP.

Adjustments will be necessary in some circumstances where its local GAAP differs from UK GAAP. Whilst this session focuses on loan relationships, other areas could require adjustment as well (for example, leases).

Example

A UK branch of a foreign company makes a £100 million loan to a foreign subsidiary on 3 January 2020.

The loan carries no interest for the first two years, then interest is charged at 9% for the remaining three years, payable on 31 December each year. The loan will be repaid on 31 December 2024.

No transfer pricing adjustment arises in connection with the loan as it is considered, broadly, to correspond with an arm's length rate.

The foreign company's local GAAP requires interest to be recognised when it arises, so the UK branch does not recognise interest expense for the first two years.

Explain any adjustments required under the loan relationship rules.

Analysis

UK GAAP requires the calculation of an annual effective interest rate of the cash flows of the loan.

Time				Cash flow
0	03/01/2020	Loan granted		-100
1	31/12/2020	Interest		0
2	31/12/2021	Interest		0
3	31/12/2022	Interest		9
4	31/12/2023	Interest		9
5	31/12/2024	Interest plus redemption		109
Effective rate (IRR)				5.128%

Credits under the loan relationship rules

Year ended	Balance b/fwd	Interest 5.128%	Cash flow	Balance c/fwd
	-	-	100	100.000
31/12/2020	100	5.128	-	105.128
31/12/2021	105.128	5.391	-	110.519
31/12/2022	110.519	5.667	-9	107.186
31/12/2023	107.186	5.497	-9	103.683
31/12/2024	103.683	5.317	-109	0

Adjustments required

- 2020: Increase interest income by £5.128m
- 2021: Increase interest income by £5.391m
- 2022: Decrease interest income by (9 – 5.667) (£3.333m)
- 2023: Decrease interest income by (9 – 5.497) (£3.503m)
- 2024: Decrease interest income by (9 – 5.317) (£3.683m)

No UK deferred tax is needed in this case as the foreign company is not producing UK GAAP financial statements, just adjusting its non-UK GAAP profits for UK tax law.

There might be a requirement to book deferred tax in the country where the foreign company is resident, so the tax adjustments should be explained to the branch.

Contributed by Malcolm Greenbaum