

Loan relationship – anti-avoidance rules (Lecture B1264 – 19.49 minutes)

Non-market loans (s446A CTA 2009)

Where:

1. the amount recognised initially is less than the transaction price and the balancing credit is not treated as a LR credit, and
2. The lender is
 - Not a company, nor
 - Is a company resident or effectively managed in a non-qualifying territory

No LR debit is allowed for the initial discount.

Corporate lenders are taxed on P&L amounts credited in respect of the discount, even though their initial debit to 'investment in subsidiary' is not deductible.

Look for unusual additions to capital in the balance sheet and identify if it was caused by discounting loans payable, then check if lender is in a non-qualifying territory (tax havens, broadly) or is an individual.

Example

A Jersey parent lent £1,000,000 interest free to a subsidiary on 1 April 2018 when the market rate was 5% per annum.

The loan is repayable on 31 March 2023. The company has a 31 December year end.

The accounts have been properly prepared in accordance with FRS 102/IFRS (see the table below).

Calculate the adjustments needed in the CT600s for the accounting periods from 31 December 2018 to 31 December 2023.

Initial booking 1 April 2018

- | | | |
|--|------------|----------|
| • Dr Bank account | £1,000,000 | |
| • Cr Loan ($1m \div 1.05^5$) | | £783,526 |
| • Cr Equity (other shareholder reserves) | | £216,774 |

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		Balance	New loan	Revised	Interest	Bal
Year ended		b/fwd	1.4.2018	balance	expense 5%	c/fwd
31-Dec-18		0	783,526	783,526	* 29,202	812,728
31-Dec-19		812,728	-	812,728	40,636	853,364
31-Dec-20		853,364	-	853,364	42,668	896,032
31-Dec-21		896,032	-	896,032	44,802	940,834
31-Dec-22		940,834	-	940,834	47,042	987,876
31-Dec-23		987,876	-	987,876	<u>**12,124</u>	1,000,000
					<u>216,774</u>	
9 months' interest rate $(1.05^{0.75} - 1)$			*3.7270%			
3 months' interest rate $(1.05^{0.25} - 1)$			**1.2272%			

Analysis

Because the initial credit of £216,774 was not brought into account under the LR rules, the interest expense each period is also disallowed

- £29,202 should have been disallowed in the year ended 31 December 2018
- £40,636 disallowed in the year ended 31 December 2019
- £42,668 will be disallowed in the year ended 31 December 2020
- Etc....

Interest-free loans between UK companies

If an interest-free term loan is made between two UK companies in an AP beginning on or after 1 January 2016, both will initially discount the loan under FRS 102.

The lender will unwind the discount to recognise interest income each period and the borrower will unwind the discount to recognise interest expense each period.

The interest income is taxable on the lender and the interest expense is deductible for the borrower.

If the loan was granted in an accounting period beginning before 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).

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

If the loan has been amortised in the accounts because of the requirements of FRS 102 or IFRS, this needs adjustment for both the borrower and lender to ensure the CT600 and tax computation reflects the tax definition.

Example

A UK parent company lent a UK subsidiary £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 below.

Year	Bal	Accounts	Amortised
ended	b/fwd	Interest 6%	cost c/fwd
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. The amount repayable is £1m, so for tax purposes it is treated as a no interest loan.

All of the accounting interest expense must be disallowed. If the loan was granted in an accounting period beginning on or after 1 January 2016, the interest would be deductible for the borrowing company and taxable on the lending company.

Imputed (notional) interest – s446A

Transfer pricing rules (Part 4, TIOPA 2010) can lead to tax adjustments on loans made other than on arm's length terms.

Imputed interest income on non-arm's length loans gives rise to taxable LR credits. Any compensating adjustments (s174 TIOPA 2010) of interest by the borrower are allowable LR debits.

But if the loan had been discounted by the borrower, ensure that the correct amount of interest is deducted in the CT600.

Check if transfer pricing adjustments are needed when looking at related party borrowings. Quantify the amounts involved and consider if a compensating adjustment can be made in the borrower company.

Example

A UK subsidiary borrowed £1,000,000 from its UK parent company on 1 April 2018. The loan is interest free, repayable on 31 March 2023 and the market rate at which the UK subsidiary could borrow externally is 5% per annum

The provisions of Part 4, TIOPA apply so that the parent has notional interest income of 5% of £1m, i.e. £50,000 which is taxable.

The subsidiary can make a claim for a compensating adjustment of £50,000 in its CT600.

The amounts booked by each company are the same as in the previous example:

		Balance	New loan	Revised	Interest	Bal
Year ended		b/fwd	1.4.2018	balance	expense 5%	c/fwd
31-Dec-18		0	783,526	783,526	* 29,202	812,728
31-Dec-19		812,728	-	812,728	40,636	853,364
31-Dec-20		853,364	-	853,364	42,668	896,032
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31-Dec-23		987,876	-	987,876	**12,124	1,000,000
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9 months' interest rate $(1.05^{0.75} - 1)$	*3.7270%			
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Adjustments to the CT600 will be the tax interest amount minus the accounts interest

- 2018: $(37,500 - 29,202)$ £8,298
- 2019: $(50,000 - 40,636)$ £9,364
- 2020: $(50,000 - 42,668)$ £7,332
- Etc...

Late paid interest (s373 – 378 CTA 2009)

Where the lender is not within scope of corporation tax, they are only taxed on interest when received (e.g. individual, trust, pension fund).

The borrower company generally gets relief on accruals basis, so could get relief without the lender being taxed until much later.

Relief for interest debits is denied, in certain circumstances, until paid where

- The interest is not paid within 12 months of the end of the period to which it relates, and
- It is not brought into account by the lender under the loan relationship rules

When calculating tax provision, current year interest won't be paid 12 months late. Check if any prior year interest remains unpaid and check if within disallowable categories in s375 (or s378).

s.375:

- Borrowing company is a close company
- Lender is a participator, associate of a participator or a company controlled by the participator (or the participator has a major interest in the company)
- Includes where a non-resident property business is close

s.375(4A)

- The lender is resident for tax in a non-qualifying territory at any time in the accrual period, or
- It is effectively managed in a non-taxing, non-qualifying territory
- Non-qualifying territories include Jersey, Guernsey, the Isle of Man, Hong Kong, the Cayman Islands and the British Virgin Islands

s.378

- The lender is an occupational pension scheme (s.378)

Other anti-avoidance rules

Loans for unallowable purposes (s441)

Loan relationship debits are disallowed where the loan is financing activities not within the scope of UK corporation tax, or used in an arrangement where one of the main purposes is tax avoidance

Always ask how the money raised for loans has been used. It is important for this, but also for the trading/non-trading distinction.

Loans to participators in a close company (s321A)

No loan relationship debit is allowed for the release or write off of the loan.

Contributed by Malcolm Greenbaum