

FINANCE BILL 2009: DRAFT LEGISLATION AMENDING THE CORPORATION TAX RULES ON LATE-PAID INTEREST BETWEEN CONNECTED COMPANIES

Introduction

1. On 28 July HMRC issued a Consultation Document entitled 'Changes to corporation tax rules on late payments of interest between connected companies'.
2. The Consultation Document concerned the rule in paragraph 2 of Schedule 9 to Finance Act 1996 which applies in a number of situations where interest payable by a debtor company to a connected person remains unpaid 12 months after the end of the accounting period, and corresponding amounts are not brought into account for tax purposes under the rules on 'loan relationships'. In such a case, the interest is deductible for tax purposes when it is paid, rather than when shown in accounts drawn up in accordance with generally accepted accounting practice, as is normally the case under the loan relationships rules. Views were invited on options for amending the rule in cases where the debtor and creditor companies are 'connected' (broadly, under common control).

The Consultation Document

3. The Consultation Document put forward two main options.

Option A: to apply paragraph 2 in all cases where the companies are connected, even where corresponding credits are taxable under the loan relationships rules. In practice, this would mean that the rule would affect interest payable by a UK-resident debtor company to a UK-resident creditor company, as well as where the creditor is resident outside the UK. The Consultation Document also identified possible variations on Option A.

Option B: to repeal paragraph 2(1A) and insert an anti-avoidance provision to address cases where there is asymmetry between debtor and creditor companies, that is, where a deduction for interest payable but unpaid is claimed by the debtor, and no corresponding receipt is taxable in the creditor.

Responses to the consultation document

4. HMRC received 30 responses on the consultation document. A number of queries on Revenue and Customs Brief 33/08 also mentioned points relating to the consultation.
5. The majority of respondents were opposed to Option A on the grounds that in their view it would increase the compliance burden on companies and result in asymmetries in tax treatment. The main arguments against Option A can be summarised as follows.
 - Companies would not be able to comply with a UK-to-UK rule simply by physical payment of the interest in question; groups with large numbers of subsidiaries commonly have centralised banking facilities and inter-company balances are not settled by cash payment between subsidiaries.
 - HMRC would need to clarify what was meant by 'paid', in particular whether it would include a book entry.

- A book/tax difference would arise from the disallowance of interest payable to connected companies, and this would complicate accounting for deferred tax.
 - In some arrangements, such as securitisations, there are restrictions on payments of connected-party debt.
 - In its overall approach Option A deviates from the basic principle that amounts taxable under the loan relationships rules should follow accounting credits and debits.
6. It was also argued that if Option A were to be adopted, there would need to be exemptions from the rule to cater for a number of situations, including
- rolled up interest;
 - indexed-linked debt (in particular for regulated entities for which price rises are RPI-linked);
 - genuine inability to pay;
 - interest imputed under transfer-pricing;
 - small and medium enterprises (SMEs).
7. A minority of respondents favoured Option A. The main arguments put forward by these respondents were that Option A would
- represent minimal change for groups in which interest is payable mainly to connected creditors outside the UK;
 - be easy to understand and give certainty of tax treatment;
 - preserve the flexibility that the current rule offers in managing intra-group payments of interest.
8. Option B was the preferred option for most respondents, but many expressed concern that uncertainty would arise from the subjective nature of an anti-avoidance rule. Other concerns were as follows.
- There is an overlap between paragraphs 2(1A) (and (1C)) with paragraph 2(1B).
 - A mandatory accruals basis would restrict the ability of a UK debtor company to defer interest deductions on loans from connected foreign creditors, which might result in trapped losses and unused Double Taxation Relief where UK and foreign profits could be matched.
 - Some respondents argued for an election to allow companies to opt for a paid basis.
 - Some respondents argued for a list of acceptable countries to which accruals-based deductions would be allowed under normal loan relationships rules.
9. HMRC has taken account of the comments made by respondents in developing proposals for amending the current rule. Draft legislation is set out in full below.

A summary of the draft legislation

10. The draft legislation would amend the late-interest rule (currently in paragraph 2 Schedule 9 FA 1996), and the similar equivalent rule on deeply discounted securities (currently in paragraph 17 Schedule 9 FA 1996) in the rewritten

legislation in the proposed Corporation Tax Act, which is due to come into force from 1 April 2009.

11. The draft legislation can be summarised as follows.

- The late-interest rule in relation to connected companies (currently paragraph 2(1A)) and 'major-interest' companies (currently paragraph 2(1C)) would be disapplied except where either of the two following conditions apply.
- The first condition is that the creditor company is not resident in a 'qualifying territory'. The meaning of 'qualifying territory' would be derived from paragraph 5E of Schedule 28AA to ICTA 1988. A list of qualifying territories can be found in the HMRC International Manual at INTM432112.
- The second condition is that the debtor company is party to an arrangement, the purpose of which is to secure a deduction for the UK debtor company with no corresponding credit brought in for tax purposes either under the loan relationships rules or under an equivalent foreign tax rule. This condition is an anti-avoidance rule.
- Where either condition applies, the debtor company would get relief for interest payable but unpaid 12 months after the end of the accounting period in which it accrues, when it is paid.
- In the majority of cases, therefore, a debtor company would be allowed a deduction for interest payable to a connected creditor company under normal loan relationships principles. A 'paid basis' would only apply where the creditor company is resident in a small number of 'non-qualifying territories', or where the debtor is party to an avoidance scheme. In neither scenario would the debtor company lose its deduction for interest payable to the connected creditor, although there would be a timing difference.
- The same principle would apply in relation to debits arising to a debtor company on a deeply discounted security issued to a connected creditor company.
- The same principle would apply to late interest payable to a participator (the rule currently in paragraph 2(1B)), where the participator is a company that also falls within the definition of a connected company or a 'major interest' company.

Commencement and transitional arrangements

12. The legislation would have effect for accounting periods beginning on or after 1 April 2009. A company would be able to elect for the current basis to continue to apply for the first accounting period beginning on or after 1 April 2009.
13. No special rules are prescribed for interest accruing but unpaid in accounting periods beginning before 1 April 2009.

14. Debits disallowed under the rule as it currently stands will be deductible in accordance with the rules as they stood before the amendments to the legislation, that is, when the interest is paid.
15. Where amounts should have been disallowed in earlier periods but were not, either because returns were accepted without challenge, or because of the decision set out in Revenue and Customs Brief 33/08 not to pursue points relating to paragraph 2 for currently open periods, no adjustments will be needed in relation to those earlier periods.

Comments

HMRC would welcome views on the draft legislation. Comments should be sent by 16 January 2009 to

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Draft legislation: loan relationships involving connected parties

The Schedule contains provision about loan relationships involving connected parties.

Introduction

1 Part 5 of CTA 2009 (loan relationships) is amended as follows.

Section 374

2 (1) Section 374 (connection between debtor and person standing in position of creditor) is amended as follows.

(2) In subsection (1)—

(a) in paragraph (a), after “relationship” insert “(“D””,

(b) in paragraph (b), after “company” insert “(“C””, and

(c) insert at the end (not as part of paragraph (b))—

“and the first or second condition is met.”

(3) After that subsection insert—

“(1A) The first condition is that C is resident in a non-qualifying territory at any time in the actual accrual period.

(1B) In subsection (1A)—

“non-qualifying territory” has the meaning given by paragraph 5E of Schedule 28AA to ICTA, and

“resident” has the meaning given by paragraph 5B(6) of that Schedule.

(1C) The second condition is that D is a party to relevant arrangements.

(1D) In subsection (1C) “relevant arrangements” means arrangements the main purpose, or one of the main purposes, of which is to secure both of the following two outcomes; and for this purpose “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

(1E) The first outcome is that debits relating to interest unpaid under D’s debtor relationship at the end of the period of 12 months following the end of the accounting period in which it would be treated as accruing (apart from this Chapter) are brought into account for the purposes of this Part before it is paid.

(1F) The second outcome is that—

(a) credits representing the full amount of the interest are not brought into account for the purposes of this Part in respect of the corresponding creditor relationship for any accounting period, or

(b) amounts representing that full amount are not taken into account for computing C’s income under a relevant foreign tax rule.

(1G) In subsection (1F) “relevant foreign tax rule” means a rule equivalent to the general rule in section 307(2) which forms part of the law of a territory outside the United Kingdom.”

Sections 375 and 376

3 (1) Section 375 (loans to close companies by participators etc) is amended as follows.

(2) In subsection (1), omit the “and” at the end of paragraph (a) and insert at the end—

“(c) there is for the actual accrual period no connection between the company which has the debtor relationship (“D”) and a company standing in the position of creditor as respects the loan relationship, and

(d) there is no time in the actual accrual period when D has a major interest in a company standing in the position of creditor as respects the loan relationship or when such a company has a major interest in D.”

(3) In subsection (2)(a), for “the company which has the debtor relationship (“D”)” substitute “D”.

4 In section 376 (interpretation of section 375), after subsection (3) insert—

“(3A) Section 466 (companies connected for an accounting period) applies for the purposes of section 375.

(3B) For the meaning of “major interest”, see section 473.”

Section 377

5 (1) Section 377 (party to loan relationship having major interest in other party) is amended as follows.

- (2) The existing provision becomes subsection (1) of that section.
- (3) In that subsection, omit the “and” at the end of paragraph (a) and insert at the end “and
(c) the first or second condition is met.”
- (4) After that subsection insert—
- “(2) The first condition is that C is resident in a non-qualifying territory at any time in the actual accrual period.
- (3) In subsection (2)—
- “non-qualifying territory” has the meaning given by paragraph 5E of Schedule 28AA to ICTA, and
“resident” has the meaning given by paragraph 5B(6) of that Schedule.
- (4) The second condition is that D is a party to relevant arrangements.
- (5) In subsection (4) “relevant arrangements” means arrangements the main purpose, or one of the main purposes, of which is to secure both of the following two outcomes; and for this purpose “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).
- (6) The first outcome is that debits relating to interest unpaid under D’s debtor relationship at the end of the period of 12 months following the end of the accounting period in which it would be treated as accruing (apart from this Chapter) are brought into account for the purposes of this Part before it is paid.
- (7) The second outcome is that—
- (a) credits representing the full amount of the interest are not brought into account for the purposes of this Part in respect of the corresponding creditor relationship for any accounting period, or
- (b) amounts representing that full amount are not taken into account for computing C’s income under a relevant foreign tax rule.
- (8) In subsection (7) “relevant foreign tax rule” means a rule equivalent to the general rule in section 307(2) which forms part of the law of a territory outside the United Kingdom.
- (9) For the meaning of “major interest”, see section 473.”

Section 407

- 6 (1) Section 407 (postponement until redemption of debits for connected companies’ deeply discounted securities) is amended as follows.
- (2) In subsection (1)—
- (a) in paragraph (b), after “company” insert (“the creditor company”),
- (b) omit the “and” at the end of paragraph (d), and

- (c) insert at the end “, and
(f) the first or second condition is met.”

(3) After that subsection insert—

“(1A) Condition A is that the creditor company is resident in a non-qualifying territory at any time in the relevant period.

(1B) In subsection (1A)—

“non-qualifying territory” has the meaning given by paragraph 5E of Schedule 28AA to ICTA, and

“resident” has the meaning given by paragraph 5B(6) of that Schedule.

(1C) Condition B is that the issuing company is a party to relevant arrangements.

(1D) In subsection (1C) “relevant arrangements” means arrangements the main purpose, or one of the main purposes, of which is to secure both of the following two outcomes; and for this purpose “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

(1E) The first condition is that any debit relating to the amount of the discount which is referable to the relevant period is brought into account for the purposes of this Part for the relevant period.

(1F) The second condition is that—

(a) credits representing the full amount of the discount which is referable to the relevant period are not brought into account for the purposes of this Part as respects the corresponding creditor relationship for any accounting period, or

(b) amounts representing that full amount are not taken into account for computing the creditor company’s income under a relevant foreign tax rule.

(1G) In subsection (1F) “relevant foreign tax rule” means a rule equivalent to the general rule in section 307(2) which forms part of the law of a territory outside the United Kingdom.”

Commencement and transitional provision

7 (1) The amendments made by this Schedule have effect where the actual accrual period (within the meaning of Chapter 8 of Part 5 of CTA 2009), or the relevant period (within the meaning of section 407(1) of that Act), begins on or after 1 April 2009.

(2) But a company may elect that any or all of the amendments made by this Schedule do not have effect where the actual accrual period, or the relevant period, is the first accounting period of the company beginning on or after that date.

(3) An election under sub-paragraph (2) must be made in the corporation tax return for the accounting period in relation to which the election is to have effect.