

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

## **Introduction**

1. In July 2008 HMRC issued a Consultation Document on options for amending the rules in Schedule 9 to Finance Act 1996 which apply 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 corporation tax purposes. In such a case, the interest is deductible for tax purposes only when it is paid, rather than on an accruals basis in accordance with the normal loan relationships rules.
2. Two options were put forward for amending this 'late interest rule': to apply the late interest rule in all cases involving connected companies including those where the creditor company is taxed under the loan relationships rules (in effect to apply it in a UK-UK context); or to repeal the late interest rule as it applies to connected companies and insert an anti-avoidance rule instead. Responses to the Consultation Document broadly favoured the second approach, with reservations about the anti-avoidance provision.
3. Draft legislation was published in December 2008 and comments were invited. In summary, the legislation would have disapplied the late interest rule in relation to 'connected' companies (currently paragraph 2(1A) Schedule 9 FA 96) and 'major-interest' companies (currently paragraph 2(1C)), and the equivalent rule on deeply discounted securities (currently in paragraph 17), except where the creditor was not resident in a 'qualifying territory', or where the debtor company was party to an avoidance arrangement.
4. Responses to the draft clauses questioned the need for, and the application of, the anti-avoidance provision, and expressed the view that the amended legislation would not adequately address the application of the late interest rule where the creditor is a company that is a close company participator in the debtor company.
5. HMRC is now publishing a further version of the draft legislation, and comments are invited on this.

## **A summary of the amended draft legislation**

6. The draft legislation would amend the rules currently in Schedule 9 FA 96, which are being rewritten in the proposed Corporation Tax Act 2009.
7. Under the amended draft legislation the following legislation would only apply where the creditor is located in a 'non-qualifying territory':
  - the late-interest rule in relation to connected companies (currently paragraph 2(1A)), company creditors that are close company participators (currently paragraph 2(1B)(c), and 'major-interest' companies (currently paragraph 2(1C));
  - the deeply discounted securities ('DDS') rule in relation to securities issued between connected companies (currently paragraph 17), and securities held by company creditors that are close company participators (currently paragraph 18).

8. The amended legislation differs from that published in December 2008 in the following respects.
- It does not contain the 'relevant arrangements' condition.
  - The disapplication of the late interest and DDS rule is extended to cases in which the creditor is a company that is a participator in the debtor company. Accordingly the rule in the previous version that disapplied paragraph 2(1B)(cc) in cases where paragraphs 2(1A) and 2(1B) also applied is unnecessary.
  - The definition of 'resident' in a 'non-qualifying territory' is extended to take in the concept of 'effective management', to address the case in which a company may not be 'liable to tax by reason of domicile, residence or place of management'. The legislation defines this as 'effectively managed in a non-taxing, non-qualifying territory'. The effect is that a company will be caught by the late interest rule even if it is located in a jurisdiction that does not levy an income tax or corporation tax on profits, or one that only taxes local-source income. The definition of a 'non-qualifying territory' is, as previously, taken from paragraph 5E Schedule 28AA ICTA 1988.
  - This same definition of 'resident' would also apply for the purposes of the exception for 'CIS-based close companies' in the rule currently in paragraph 2(1B).

### **Commencement and transitional arrangements**

9. The amended rules would have effect for accounting periods beginning on or after 1 April 2009. A company will be able to elect for the current basis to continue to apply for the first accounting period beginning on or after 1 April 2009, but the amended legislation now contains an end date by which the election must be made. As before, no special rules are prescribed for interest accruing but unpaid in accounting periods beginning before 1 April 2009.

### **Comments**

Comments are invited on

- the amended draft clauses
- guidance on these changes

should be sent by 9 April 2009, preferably by e mail, 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 (late interest: connection between debtor and person standing in position of creditor) is amended as follows.

(2) In subsection (1)—

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

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

“and the condition in subsection (1A) is met.”

(3) After that subsection insert—

“(1A) The condition is that C is—

(a) resident for tax purposes in a non-qualifying territory at any time in the actual accrual period, or (b) effectively managed in a non-taxing non-qualifying territory at any such time.”

(4) Insert at the end—

“(3) For the purposes of this section—

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

(b) a non-qualifying territory is “non-taxing” if companies are not under its law liable to tax by reason of domicile, residence or place of management, and

(c) “resident for tax purposes” means liable, under the law of the non-qualifying territory, to tax there by reason of domicile, residence or place of management.”

### *Sections 375 and 376*

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

(2) In subsection (1), insert at the end (not as part of paragraph (b))—

“and, where subsection (4A) applies, the non-qualifying territory condition is met.”

(3) In subsections (3)(b) and (4)(b), after “resident” insert “for tax purposes”.

(4) After subsection (4) insert—

“(4A) This subsection applies if C is a company; and the non-qualifying territory condition is that C is—

(a) resident for tax purposes in a non-qualifying territory at any time in the actual accrual period, or

(b) effectively managed in a non-taxing non-qualifying territory at any such time.”

4 (1) Section 376 (interpretation of section 375) is amended as follows.

(2) In subsection (5), for the definition of “resident” substitute—

““resident for tax purposes” means liable, under the law of the non-qualifying territory, to tax there by reason of domicile, residence or place of management, and”.

(3) Insert at the end—

“(6) For the purposes of section 375, a non-qualifying territory is “nontaxing” if companies are not under its law liable to tax by reason of domicile, residence or place of management.”

#### *Section 377*

5 (1) Section 377 (late interest: 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 condition in subsection (2) is met.”

(4) After that subsection insert—

“(2) The condition is that C is—

(a) resident for tax purposes in a non-qualifying territory at any time in the actual accrual period, or

(b) effectively managed in a non-taxing non-qualifying territory at any such time.

(3) For the purposes of this section—

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

(b) a non-qualifying territory is “non-taxing” if companies are not under its law liable to tax by reason of domicile, residence or place of management, and

(c) “resident for tax purposes” means liable, under the law of the non-qualifying territory, to tax there by reason of domicile, residence or place of management.”

#### *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 condition in subsection (1A) is met.”

(3) After that subsection insert—

“(1A) The condition is that the creditor company is—

(a) resident for tax purposes in a non-qualifying territory at any time in the relevant period, or (b) effectively managed in a non-taxing non-qualifying territory at any such time.”

(4) Insert at the end—

“(6) For the purposes of this section—

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

(b) a non-qualifying territory is “non-taxing” if companies are not under its law liable to tax by reason of domicile, residence or place of management, and  
(c) “resident for tax purposes” means liable, under the law of the non-qualifying territory, to tax there by reason of domicile, residence or place of management.”

*Sections 409 and 410*

7 Section 409(1) (postponement until redemption of debits for close companies’ deeply discounted securities)—

(a) in paragraph (b), after “there is a person” insert “(“C””, and

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

“and, where it applies, the non-qualifying territory condition is met.”

8 (1) Section 410 (interpretation of section 409) is amended as follows.

(2) In subsections (3)(b) and (4)(b), after “resident” insert “for tax purposes”.

(3) After subsection (4) insert—

“(4A) The non-qualifying territory condition applies if C is a company; and the non-qualifying territory condition is that C is—

(a) resident for tax purposes in a non-qualifying territory at any time in the relevant period, or (b) effectively managed in a non-taxing non-qualifying territory at any such time.”

(4) In subsection (5), for the definition of “resident” substitute—

““resident for tax purposes” means liable, under the law of the non-qualifying territory, to tax there by reason of domicile, residence or place of management, and”.

(5) After that subsection insert—

“(5A) For the purposes of this section, a non-qualifying territory is “nontaxing” if companies are not under its law liable to tax by reason of domicile, residence or place of management.”

*Commencement and transitional provision*

9 (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) or 409(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 in relation to the first accounting period for which they would otherwise apply.

(3) However, no election may be made under sub-paragraph (2) in relation to an accounting period ending after 31 March 2011.

(4) 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.

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**Draft amendments to guidance in the Corporate Finance Manual on the late interest rule (similar material will be added to the guidance on the parallel rules for deeply discounted securities)**

**Loan relationships: connected persons and late interest: changes to the rule for accounting periods beginning on or after 1 April 2009**

For accounting periods beginning on or after 1 April 2009, CTA09/S374, S375, and S376, which deal respectively with cases where the creditor is a 'connected company' (CFMxxxx), a close company participator (CFMxxxx), or a 'major interest company' (CFMxxxx), each contain a condition that the late interest rule will only apply where the creditor is a company that is 'resident' or 'effectively managed' in a 'non-taxing, non-qualifying territory'.

'Non-qualifying territory' takes its meaning from ICTA88/SCH28AA/PARA5E, and is explained at INTM432112. It means any territory that is not a 'qualifying territory' – that is, a territory with which the UK has a double taxation treaty that contains a non-discrimination article'. The list of qualifying territories at INTM432112 includes all EU countries and the majority of other normal tax jurisdictions. It excludes tax havens and similar jurisdictions.

'Resident' means 'liable to tax by reason of domicile, residence, or place of management'. 'Effectively managed in a non-taxing, non-qualifying territory' refers to a territory other than one in which companies are liable to tax by reason of domicile, residence or place of management. The effect of the words 'effectively managed' is that a company will be caught by the late interest rule even if it is located in a jurisdiction that does not levy an income tax or corporation tax on profits, or one that only taxes local-source income.

As a result of these changes, with effect for accounting periods beginning on or after 1 April 2009, in the majority of cases where the creditor is a company, unless that company is located in a tax haven, normal loan relationships principles will apply, and interest will be deductible as it accrues in the accounts, not when it is paid.

**Transition to the new rules**

A company may elect for the 'paid basis' to apply for the first accounting period beginning on or after 1 April 2009. This provides time for groups for which the 'paid basis' is advantageous to rearrange their inter-company loans. The election must be made by 31 March 2011, in the tax return for the period in question.

No special rules are prescribed for interest accruing but unpaid in accounting periods beginning before 1 April 2009. Debits disallowed under the rule as it stood before April 2009 will be deductible in accordance with the rules before the amendments took place; that is, when the interest is paid.

In some cases, interest should have been disallowed in earlier periods but may not have been, either because returns were accepted without challenge, or because of the decision set out in Revenue and Customs Brief 33/08 issued in July 2008 not to pursue points relating to paragraph 2 for periods that were open at that time. The amount allowable in periods after 1 April 2009 is the amount not previously allowed. Where it is necessary for a company to keep track of brought forward interest, some of which has been deducted in computations for early periods and some of which has not, any reasonable method of apportionment will be accepted.