

AVOIDANCE INVOLVING FINANCIAL ARRANGEMENTS

Repeal of rent factoring provisions

- 1 (1) Sections 43A to 43G of ICTA (rent factoring) shall cease to have effect.
- (2) The amendment made by this paragraph has effect in relation to transactions entered into on or after 6th June 2006.

Structured finance agreements: factoring of income receipts etc

- 2 (1) After section 774 of ICTA (transactions between dealing company and associated company) insert—

*“Factoring of income receipts etc***774A Meaning of “structured finance arrangement” for purposes of s.774B**

- (1) For the purposes of section 774B an arrangement is a structured finance arrangement in relation to a person (“the borrower”) if the following condition is met in relation to the borrower.
- (2) The condition is that—
 - (a) the borrower receives from another person (“the lender”) any money or other asset (“the advance”) under the arrangement,
 - (b) in accordance with generally accepted accounting practice the accounts of the borrower record a financial obligation in respect of the advance,
 - (c) the borrower, or a person connected with the borrower, makes a disposal of an asset (“the security”) under the arrangement to or for the benefit of the lender or a person connected with the lender, and
 - (d) the lender, or a person connected with the lender, is entitled under the arrangement to payments in respect of the security.
- (3) For the purposes of this section, in any case where the borrower is a partnership, the reference to the accounts of the borrower includes the accounts of any member of the partnership.

774B Disregard of intended effects of arrangement involving disposals of assets

- (1) If—
 - (a) an arrangement is a structured finance arrangement in relation to a person (“the borrower”), and
 - (b) the arrangement would (disregarding this section) have had the relevant effect (see subsections (2) and (3)),the arrangement is not to have that effect.
- (2) If the borrower is a person other than a partnership, the relevant effect is that—
 - (a) an amount of income on which the borrower, or a person connected with the borrower, would otherwise have been charged to tax is not so charged,
 - (b) an amount which would otherwise have been brought into account in calculating for tax purposes any income of the

- borrower, or of a person connected with the borrower, is not so brought into account, or
- (c) the borrower, or a person connected with the borrower, would otherwise have become entitled to an income deduction.
- (3) If the borrower is a partnership, the relevant effect is that –
- (a) an amount of income on which a member of the partnership would otherwise have been charged to tax is not so charged,
- (b) an amount which would otherwise have been brought into account in calculating for tax purposes any income of a member of the partnership is not so brought into account, or
- (c) a member of the partnership would otherwise have become entitled to an income deduction.
- (4) If –
- (a) a person in relation to whom the structured finance arrangement would otherwise have had the relevant effect is a person within the charge to income tax, and
- (b) in accordance with generally accepted accounting practice the accounts of the person record an amount as a finance charge in respect of the advance,
- that person may treat the amount for income tax purposes as interest payable on a loan.
- (5) If a person in relation to whom the structured finance arrangement would otherwise have had the relevant effect is a company within the charge to corporation tax –
- (a) the advance is to be treated, in relation to the company, for the purposes of Chapter 2 of Part 4 of the Finance Act 1996 as a money debt owed by the company,
- (b) the arrangement is to be treated, in relation to the company, for the purposes of that Chapter as a loan relationship of the company (as a debtor relationship), and
- (c) any amount which, in accordance with generally accepted accounting practice, is recorded in the accounts of the company as a finance charge in respect of the advance is to be treated as interest payable under that relationship.
- (6) For the purposes of this section, in any case where the borrower is a partnership, –
- (a) references to accounts include the accounts of the partnership, and
- (b) any deemed interest is treated as payable by the partnership (whether or not the finance charge is recorded in the accounts of the partnership).
- (7) For the purpose of determining when any deemed interest in respect of the advance is paid –
- (a) the payments mentioned in section 774A(2)(d) are treated as consisting of amounts for repaying the advance and amounts (“the interest elements”) in respect of interest on the advance, and

- (b) the interest elements of those payments are treated as paid when those payments are paid,
and the deemed interest in respect of the advance is treated as paid at the times when the interest elements are treated as paid.
- (8) In this section “deemed interest” means any amount which is treated as interest as a result of subsection (4) or (5).
- (9) This section is subject to the exceptions contained in section 774E.

774C Meaning of “structured finance arrangement” for purposes of s.774D

- (1) For the purposes of section 774D an arrangement is a structured finance arrangement in relation to a partnership (“the borrower partnership”) if condition A or B is met in relation to the borrower partnership.
- (2) Condition A is that—
 - (a) a person (“the transferor partner”) disposes of an asset (“the security”) under the arrangement to the borrower partnership,
 - (b) the transferor partner is a member of the borrower partnership immediately after the disposal (whether or not a member immediately before the disposal),
 - (c) the borrower partnership receives from another person (“the lender”) any money or other asset (“the advance”) under the arrangement,
 - (d) in accordance with generally accepted accounting practice the accounts of the borrower partnership record a financial obligation in respect of the advance,
 - (e) there is a relevant change in relation to the membership of the borrower partnership involving the lender or a person connected with the lender (see subsection (6)), and
 - (f) under the arrangement the share of the lender or person connected with the lender in the profits of the borrower partnership is determined by reference (wholly or partly) to payments in respect of the security.
- (3) For the purposes of condition A, the reference to the accounts of the borrower partnership includes the accounts of the transferor partner.
- (4) Condition B is that—
 - (a) the borrower partnership holds an asset (“the security”) as a partnership asset at any time before the arrangement is made,
 - (b) the borrower partnership receives from another person (“the lender”) any money or other asset (“the advance”) under the arrangement,
 - (c) in accordance with generally accepted accounting practice the accounts of the borrower partnership record a financial obligation in respect of the advance,
 - (d) there is a relevant change in relation to the membership of the borrower partnership involving the lender or a person connected with the lender, and
 - (e) under the arrangement the share of the lender or person connected with the lender in the profits of the borrower

partnership is determined by reference (wholly or partly) to payments in respect of the security.

- (5) For the purposes of condition B, the reference to the accounts of the borrower partnership includes the accounts of any person who is a member of the partnership immediately before the arrangement is made.
- (6) For the purposes of this section and section 774D there is a relevant change in relation to the membership of the borrower partnership involving the lender or a person connected with the lender if directly or indirectly in consequence of, or otherwise in connection with, the arrangement—
 - (a) the lender, or a person connected with the lender, becomes a member of the borrower partnership at any time, or
 - (b) there is at any time a change in the share of a member of the borrower partnership in the profits of the borrower partnership in a case where that member is the lender or a person connected with the lender.
- (7) For the purposes of subsection (6)(b) the reference to a person connected with the lender includes a person who at any time becomes connected with the lender directly or indirectly in consequence of, or otherwise in connection with, the arrangement.

774D Disregard of intended effects of arrangement involving change in relation to a partnership

- (1) This section applies if—
 - (a) an arrangement is a structured finance arrangement in relation to a partnership (“the borrower partnership”), and
 - (b) any relevant change in relation to the membership of the borrower partnership involving the lender or a person connected with the lender would (disregarding this section) have had the following effect.
- (2) The effect is that—
 - (a) an amount of income on which a relevant member of the borrower partnership would otherwise have been charged to tax is not so charged,
 - (b) an amount which would otherwise have been brought into account in calculating for tax purposes any income of a relevant member of the borrower partnership is not so brought into account, or
 - (c) a relevant member of the borrower partnership would otherwise have become entitled to an income deduction.
- (3) In this section “relevant member of the borrower partnership” means—
 - (a) in any case where condition A in section 774C is met in relation to the arrangement, the transferor partner, and
 - (b) in any case where condition B in that section is met in relation to the arrangement, any person other than the lender who is a member of the borrower partnership immediately before the time at which the relevant change in relation to the

membership of the borrower partnership involving the lender or a person connected with the lender occurs.

- (4) Part 9 of ITTOIA 2005 and section 114 above are to have effect in relation to any relevant member of the borrower partnership as if the relevant change in relation to the membership of the borrower partnership involving the lender or a person connected with the lender had not occurred.

Accordingly, the structured finance arrangement is not to have the effect mentioned in subsection (2).

- (5) The following provisions of this section confer relief from tax the availability of which depends on which of the conditions in section 774C is met in relation to the arrangement.

- (6) In any case where condition A in section 774C is met, if –
- (a) the transferor partner is a person within the charge to income tax, and
 - (b) in accordance with generally accepted accounting practice the accounts of the borrower partnership record an amount as a finance charge in respect of the advance,

the transferor partner may treat the amount for income tax purposes as interest payable by the transferor partner on a loan.

- (7) In any case where condition A in that section is met, if the transferor partner is a company within the charge to corporation tax –
- (a) the advance is to be treated, in relation to the company, for the purposes of paragraph 19 of Schedule 9 to the Finance Act 1996 (and the other provisions of Chapter 2 of Part 4 of that Act) as a money debt owed by the borrower partnership,
 - (b) the arrangement is to be treated, in relation to the company, as a transaction for the lending of money from which that debt is treated as arising for those purposes, and
 - (c) any amount which, in accordance with generally accepted accounting practice, is recorded in the accounts of the borrower partnership as a finance charge in respect of the advance is to be treated as interest payable by the company under that transaction.

- (8) For the purposes of subsections (6) and (7), references to the accounts of the borrower partnership include the accounts of the transferor partner.

- (9) In any case where condition B in section 774C is met, if –
- (a) a relevant member of the borrower partnership is a person within the charge to income tax, and
 - (b) in accordance with generally accepted accounting practice the accounts of the borrower partnership record an amount as a finance charge in respect of the advance,

the relevant partner may treat the amount for income tax purposes as interest payable by the borrower partnership on a loan.

- (10) In any case where condition B in that section is met, if a relevant member of the borrower partnership is a company within the charge to corporation tax –

- (a) the advance is to be treated, in relation to the company, for the purposes of paragraph 19 of Schedule 9 to the Finance Act 1996 (and the other provisions of Chapter 2 of Part 4 of that Act) as a money debt owed by that partnership,
 - (b) the arrangement is to be treated, in relation to the company, as a transaction for the lending of money from which that debt is treated as arising for those purposes, and
 - (c) any amount which, in accordance with generally accepted accounting practice, is recorded in the accounts of the borrower partnership as a finance charge in respect of the advance is to be treated as interest payable by the borrower partnership under that transaction.
- (11) For the purposes of subsections (9) and (10), references to the accounts of the borrower partnership include the accounts of any relevant member of the borrower partnership.
- (12) For the purpose of determining when any deemed interest in respect of the advance is paid –
- (a) the payments mentioned in section 774C(2)(f) or (4)(e) are treated as consisting of amounts for repaying the advance and amounts (“the interest elements”) in respect of interest on the advance, and
 - (b) the interest elements of those payments are treated as paid when those payments are paid,
- and the deemed interest in respect of the advance is treated as paid at the times when the interest elements are treated as paid.
- (13) In this section “deemed interest” means any amount which is treated as interest as a result of any of subsections (6) to (10).
- (14) This section is subject to the exceptions contained in section 774E.

774E Sections 774B and 774D: exceptions

- (1) Section 774B or 774D does not apply if the whole of the advance (within the meaning of the applicable section) –
- (a) is charged to tax on a relevant person as an amount of income,
 - (b) is brought into account in calculating for tax purposes any income of a relevant person, or
 - (c) is brought into account for the purposes of any provision of the Capital Allowances Act as a disposal receipt, or proceeds from a balancing event or disposal event, of a relevant person.
- (2) For this purpose a “relevant person” means –
- (a) if section 774B applies, a person in relation to whom the structured finance arrangement would (but for that section) otherwise have had the relevant effect (within the meaning of that section), and
 - (b) if section 774D applies, a relevant member of the borrower partnership (within the meaning of that section).
- (3) Subsection (1)(c) is not to be taken as met in any case where –
- (a) the receipt or proceeds gives rise to a balancing charge, and

- (b) the amount of the balancing charge is limited by any provision of the Capital Allowances Act.
- (4) Section 774B or 774D does not apply in so far as the structured finance arrangement is an arrangement in relation to which—
 - (a) section 263A of the 1992 Act (agreements for sale and repurchase of securities) applies, or
 - (b) paragraph 15 of Schedule 9 to the Finance Act 1996 (repo transactions and stock-lending) applies.
- (5) Section 774B or 774D does not apply in so far as the structured finance arrangement is an arrangement in relation to which Chapter 5 of Part 2 of the Finance Act 2005 has effect.
- (6) The Treasury may make regulations prescribing other circumstances in which section 774B or 774D is not to apply in relation to a structured finance arrangement.
- (7) The regulations may make—
 - (a) different provision for different cases or different purposes, and
 - (b) incidental, supplemental, consequential or transitional provision and savings.
- (8) The regulations may make provision having effect before the date on which they are made.

774F Sections 774A to 774D: minor definitions etc

- (1) For the purposes of sections 774A to 774D “arrangement” includes any agreement or understanding (whether or not legally enforceable).
- (2) For the purposes of sections 774A to 774D “income deduction” means—
 - (a) a deduction in calculating any income for tax purposes, or
 - (b) a deduction against total income or (as the case may be) total profits.
- (3) For the purposes of sections 774A to 774D—
 - (a) references to a person’s receiving any asset include the person’s obtaining directly or indirectly the value of any asset or otherwise deriving directly or indirectly any benefit from it,
 - (b) references to a disposal of an asset include anything which constitutes a disposal of the asset for the purposes of the 1992 Act,
 - (c) references to payments in respect of any asset include obtaining directly or indirectly the value of any asset or otherwise deriving directly or indirectly any benefit from it.
- (4) For the purposes of sections 774A to 774D, section 839 (connected persons) applies.
- (5) For the purposes of sections 774A to 774D references to the accounts of any person who is a company include the consolidated group accounts of a group of companies of which it is a member.

- (6) If any person does not draw up accounts in accordance with generally accepted accounting practice, sections 774A to 774D apply as if the accounts had been drawn up by the person in accordance with that practice.
 - (7) Sections 277 to 281 of ITTOIA 2005 and section 34 above (lease premiums) are not to apply in relation to a premium paid in respect of a grant of a lease where the grant constitutes a disposal of an asset for the purposes of section 774A(2)(c) or 774C(2)(a).”.
- (2) The amendment made by this paragraph has effect in relation to any arrangements whenever made (but see sub-paragraphs (3) and (4)).
 - (3) In relation to arrangements made before 6th June 2006, amounts are, as a result of the amendment made by this paragraph, –
 - (a) to be charged to tax, or
 - (b) to be brought into account in calculating any income for tax purposes or deducted from any income for tax purposes, only if the amounts arise on or after that date.
 - (4) The amendment made by this paragraph has no effect in relation to any arrangement made before that date in so far as section 43B or 43D of ICTA (rent factoring) applies to it.
 - (5) In any case where, in relation to arrangements made before that date, a person is treated, as a result of the amendment made by this paragraph, as being a party to any loan relationship –
 - (a) a period of account is to be treated for the purposes of Chapter 2 of Part 4 of FA 1996 as beginning on that date, and
 - (b) the loan relationship is to be treated for those purposes as being entered into by the person for a consideration equal to the notional carrying value of the liability representing the relationship.
 - (6) For this purpose, the notional carrying value is the amount that would have been the carrying value of the liability in the accounts of the person if a period of account had ended immediately before that date.
 - (7) “Carrying value” has the same meaning here as it has for the purposes of paragraph 19A of Schedule 9 to FA 1996.

Rent factoring of leases of plant or machinery

- 3 (1) Section 785A of ICTA (rent factoring of leases of plant or machinery) is amended as follows.
- (2) After subsection (5) (provision about partnerships with legal personality) insert –
 - “(5A) This section does not apply in so far as section 774B or 774D (structured finance arrangements) applies in relation to the arrangements mentioned in paragraph (c) of subsection (1) above as a result of the transfer mentioned in that paragraph.”.

Transactions associated with loans or credit

- 4 (1) Section 786 of ICTA (transactions associated with loans or credit) is amended as follows.

- (2) After subsection (5) (transaction under which a person assigns, surrenders etc income arising from property) insert –

“(5ZA) But subsection (5) above does not apply if the person mentioned in that subsection is, as a result of section 774B or 774D (structured finance arrangements), chargeable to tax on the amount of income assigned, surrendered, waived or forgone.”.

Structured finance arrangements: chargeable gains treatment of acquisitions and disposals

- 5 (1) After section 263D of TCGA 1992 (gains accruing to persons paying manufactured dividends) insert –

“263E Structured finance arrangements

- (1) This section applies if –
- (a) section 774B of the Taxes Act (disregard of intended effects of arrangement involving disposals of assets) applies in relation to a structured finance arrangement,
 - (b) the borrower or a person connected with the borrower makes a disposal of any security at any time under the arrangement to or for the benefit of the lender or a person connected with the lender, and
 - (c) condition A or B is met.
- (2) Condition A is that the person making the disposal subsequently acquires under the arrangement the asset disposed of by that disposal.
- (3) Condition B is that –
- (a) the asset disposed of by that disposal subsequently ceases to exist at any time, and
 - (b) that asset was held by the lender, or a person connected with the lender, from the time of the disposal until that time.
- (4) The disposal of the security by the borrower or a person connected with the borrower is to be disregarded for the purposes of this Act.
- (5) Any subsequent acquisition by the person making the disposal of the asset disposed of by that disposal is to be disregarded for the purposes of this Act.
- (6) In this section –
- “the borrower”, in relation to a structured finance arrangement, means the person who is the borrower under the arrangement for the purposes of section 774A of the Taxes Act,
- “the lender”, in relation to a structured finance arrangement, means the person who is the lender under the arrangement for the purposes of that section,
- “security” means any such asset as is mentioned in subsection (2)(c) and (d) of that section.”.

- (2) The amendment made by this paragraph has effect in relation to disposals made on or after 6th June 2006.

- (3) The amendment made by this paragraph also has effect in relation to any disposal made by a person before that date if the person makes a claim to that effect under this sub-paragraph.

EXPLANATORY NOTES

Background

1 Where a person obtains finance by way of a loan, the finance provider (say a bank) is repaid both interest and the loan principal. The borrower normally gets tax relief for the interest shown in its accounts but not for the principal: correspondingly it is not taxed on the receipt of the finance. The finance provider is taxed on the interest as its profit from the lending transaction.

2 In the basic version of the avoidance scheme, a person, call him "Borrower", makes a disposal of an asset ("underlying asset") on which there is a predictable income stream, or simply transfers the right to that income stream, in return for a lump sum from another person, call him "Lender". The income stream acquired by Lender will be sufficient to repay both the lump sum and interest. In a case where an underlying asset is acquired, there are likely to be arrangements such as options under which it will revert to Borrower. Borrower will account for the arrangement as a loan, so that only the finance cost will be charged to the profit and loss account or income statement.

3 It is claimed that the income or receipts arising during the period of the arrangement is not taxable on Borrower, and that the lump sum is either a capital receipt giving rise to a gain subject only to the provisions of the Taxation of Chargeable Gains Act 1992 ("TCGA") or is not taxable at all.

4 The aim of the arrangement is to give effective tax relief to Borrower not only for the finance charge but also for the principal of the 'loan'. Compare the following examples, where a company wishes to obtain finance of £100 million over 5 years.

Example 1: the company could get a loan at interest from a finance provider. Over the five-year period, it might pay, say, £2.5m interest p.a. giving total repayments of £112.5m. For tax purposes, relief would be available for each annual amount of the £2.5m interest, but not for repayment of the £100m principal.

Example 2: the company holds an asset on which income of £22.5m a year will arise. It transfers this asset to the finance provider for a lump sum of £100m for a period of 5 years, at the end of which it can reacquire that asset for nothing. During the five years, income of total £112.5m is paid to the bank, effectively repaying the lump sum with interest.

The company claims the £100m sum it receives for transfer of the asset either gives rise to a capital gain (normally of a very much smaller amount because of base costs and reliefs), or is not taxable at all. It also claims that it is not taxable on the income of £112.5m, which flows to the finance provider.

The effect is that the company has got effective tax relief for the repayment of the £100m lump sum (equivalent to loan principal) as well as for the £12.5m interest.

5 The deduction generation scheme is similar in effect, but instead of foregoing a taxable income stream the avoider uses the asset to generate tax-deductible expenditure.

Example 3: Borrower has a freehold interest in land that it occupies for the purpose of its business. It grants a 51-year lease over the land to the finance provider for a premium of, say, £100 m.

The finance provider immediately grants a 5 year sublease to Borrower for payment of rent of £22.5m a year. The rent paid by Borrower will be sufficient to repay the £100m advance from the bank together with interest over the 5-year period. There will be an arrangement in place to ensure that all of the benefits of ownership will revert to Borrower at the end of 5 years. .

In substance Borrower has borrowed £100m from the finance provider, which it repays plus interest. But again the effect would be that the company would get effective tax relief (for example in a trading profit computation or a Schedule A business computation) for the repayment of £100m (equivalent to loan principal) as well as for £12.5m interest.

6 This particular scheme involving income from real property is countered by the current rent factoring legislation in section 43A to 43G Income and Corporation Tax Act 1988 (“ICTA”), but this legislation is now to be repealed. Under those rules, the £100m premium received by A would have been be taxed as income in the period of receipt. The new legislation will instead ensure that A will be taxed as it had borrowed £100m with relief given only for the £12.5m finance charge. It will operate in the same way as applies to those rent-factoring schemes described here which fall within paragraph 1(5) to (8) of Schedule 7 Finance (No. 2) Act 2005 (abolition of 15 year limit) .

7 More complex arrangements can be entered into.

Example 4: an asset held by Borrower may be transferred to a partnership of which it is a member. Lender then joins the partnership for a capital contribution of say £100m, in return for the right to receive partnership profits amounting to £112.5 m over the next 5 years. Thereafter, all of the rights to receive partnership profits will revert to the borrower (who may be able to buy out Lender’s interest for a nominal consideration or expel Lender). In substance, Lender has made a loan of £100m for the benefit of Borrower.

Again, it is claimed that Borrower is not taxable on the income of £112.5m, which flows to the partnership and allocated to Lender.

8 In all of these cases, Borrower will account for the lump sum paid by Lender as a financial obligation, with payments made to the lender in respect of the asset reducing the principal amount of that obligation over the term of the loan.

9 The measure will apply in full to finance agreements entered into on or after 6th June. But it will also apply to finance agreements entered into before today, but so that only amounts of income or receipts, and finance charges, which accrue on or after today are brought into account for tax.

Anti-avoidance measure: summary

10 The changes announced on 6th June will affect the schemes in examples 2 to 4, by restoring the tax charge on the income flowing to the finance provider (or denying relief for it) but allowing relief for any finance charge accounted for. This will achieve neutrality between these schemes and straightforward loan finance as in example 1.

11 The measure will apply where a person enters into a “structured finance agreement”. A structured finance arrangement (or “SFA”) is an arrangement where in accordance with generally accepted accounting practice (GAAP) a person (“the borrower”) records in its account a financial obligation in respect of the lump sum paid by “the lender”. The reference to accounts of the borrower includes a reference to the consolidated group accounts of a group of companies of which the borrower is a member. The following conditions must also be met:

- the borrower (or a person connected with the borrower) disposes of an asset to the lender (or a person connected with the lender)
- as a result the lender becomes entitled to amounts of income in respect of the asset. This includes any case where the lender indirectly derives any value from the asset.

12 Where there is a SFA and that arrangement would have had the effect that either:

- income or receipts that would have been brought into account on the borrower for tax purposes are not brought into account or
- the borrower would have become entitled to a deduction in computing its income or profits for tax purposes,

then

- the arrangement will not have that effect, and
- any disposal or reacquisition of assets or rights under the finance agreement, and the lump sum received, will be disregarded for the purposes of TCGA 1992 as regards the person.

13 Tax relief will be allowed for the amount of any interest or ‘finance charge’ in respect of the finance agreement shown in the borrower’s accounts. For a company, this amount will be treated as interest payable on a debtor loan relationship to which it is party, and for any other person as interest payable.

14 An arrangement will also be a SFA in two other circumstances.

15 The first is where, as in example 4 above, a partner (“the transferor partner”) disposes of an asset to the partnership and under the arrangement either

- a new member joins the partnership and takes a share in the partnership profits attributable to the asset in return for a payment to the partnership that is in substance a loan, or
- an existing partner takes an increased share in those profits in return for a payment to the partnership that in substance is a loan.

16 The second is where the partnership already holds an asset and under the arrangements either:

- a new member joins the partnership and takes a share in the partnership profits attributable to the asset in return for a payment to the partnership that is in substance a loan, or
- an existing partner takes an increased share in the profits in return for a payment to the partnership that is in substance a loan.

17 In both cases there is a requirement that in accordance with GAAP, the accounts of the partnership (including the accounts of any member of the partnership or the consolidated accounts of the group of which that partner is a member) record a financial obligation in respect of the amount advanced by the lender.

18 In the first case the transferor partner will be taxed on any income (or must bring into account any receipts) in respect of the asset as if the structured finance arrangement had not been entered into. The transferor partner will also be entitled to relief in respect of the finance charge shown in the accounts. For a company transferor, the amount will be treated as interest payable on a debtor loan relationship to which the company is party, and for any other person as interest payable.

19 In the second case, the profit shares of the existing members of the partnership will be determined as if the arrangement had not been entered into. These members will also be entitled to relief in respect of any finance charge shown in the accounts in accordance with the deemed profit share.

20 The legislation will not apply where the whole of the lump sum received is taxed as income of the person or is brought into account as a disposal receipt for the purposes of the Capital Allowances Act. Nor will it apply to:

- Sale and repurchase (repo) agreements.
- Alternative finance arrangements to which Chapter 5 of Part 2 of the Finance Act 2005 applies.

21 The rent factoring legislation in Part 2 of ICTA will be repealed. Sections 785A and 786 ICTA will also be amended.

Anti-avoidance measure: details of legislation

1 Paragraph 2 of the draft Schedule 1 inserts a series of new sections after section 774 in Part 18 of the Income and Corporation Taxes Act (“ICTA”) which deals with tax avoidance. The bundle of sections is headed “Factoring of income receipts etc” and provides a particular tax treatment for what the legislation calls “structured finance arrangements”.

2 New sections 774A and 774B deal with the definition of structured finance arrangements and their tax treatment where they involve the transfer of an asset including an income stream from a “borrower” to a “lender”. New sections 774C and 774D deal with a more complex type of arrangement involving partnerships and changes in profit sharing arrangements.

3 New section 774E sets out the exceptions from the charge and new section 774F provides some definitions that are common to the first four sections.

The simple case – sections 774A and 774B

4 Section 774A(1) provides that, in the simple case, a “structured finance arrangement” (“SFA”) is one where the conditions in section 774A(2) are met in relation to a person, who the legislation calls “the borrower”.

5 The conditions, as set out in section 774A(2), are that

- the “borrower” receives money (or some other asset) from another person, who is called the “lender”,
- that the borrower records in its accounts, and in accordance with generally accepted accounting practice (GAAP), a financial obligation in respect of the advance. This provision is taken directly from the rent-factoring legislation and in particular section 43A(1) ICTA.
- the borrower, or a person connected with him, disposes of an asset, which is labelled the “security”, to the lender, or to a person connected with him (collectively referred to from here as “the lender etc.”, or the lender etc. obtains the benefit of the asset (cf. section 43B(1) ICTA).
- as a result of that transfer the lender etc. is entitled to receive payments in respect of the security.

6 It is, of course, highly likely, that if the arrangement is accounted for as a financial obligation secured on certain assets, that there will be an advance, a transfer of the security and payments to the lender under the security, but the additional conditions make it clear that even though the transaction may be accounted for as a financial obligation it must also have these standard structural characteristics of a secured loan. Merely being accounted for as a financial obligation is not enough.

7 Section 774A(3) makes it clear that where the borrower is a partnership then the accounts to which resort may be had to determine whether the accounts record a financial obligation in accordance with GAAP include the accounts of any member of the partnership as well as of the partnership itself.

8 And see also section 774F(4) in connection with consolidated group accounts.

9 If a case is one to which section 774A applies because the subsection (2) conditions are met, then the tax treatment of the transaction is set out in new section 774B.

10 It is first necessary to determine (section 774B(1)) if the SFA would, as far as the borrower is concerned, have had what the legislation calls “the relevant effect”. If the SFA would, but for section 774B have had that relevant effect, then the arrangement is treated as not having that effect for tax purposes.

11 What the relevant effect is depends on whether the borrower is a partnership or not. In either case the test is whether one of three conditions is met.

12 The first, in section 774B(2)(a) and (3)(a) is that an amount of income which would otherwise have been charged to tax, in a non-partnership case, on the borrower, or a person connected with him, (called from here “the borrower etc.”), and in a partnership case on a member of the partnership, is not so charged. This would cover cases where the income is “pure income profit”.

13 The second, in section 774B(2)(b) and (3)(b) is that an amount which would otherwise been brought into account in calculating, in a non-partnership case, the borrower etc.’s income and in a partnership case, a member of the partnership’s income, is not so brought into account.

14 This covers receipts which form part of the calculation of a profit whether of a trade, a property business or some other business.

15 The third, in section 774B(2)(c) and (3)(c) is that, in a non-partnership case, the borrower etc.’, and in a partnership case, a member would have become entitled to an income deduction. This term is defined in section 774F(2) to mean any deduction in calculating income (e.g. an expense in a Case I or trading computation, or a Schedule A or property business computation) or a deduction against total income (for income tax cases) or total profits (for corporation tax cases).

16 This provision is to cover a case which the rent-factoring legislation currently caters for in section 43D. If the asset transferred is not one which generates income, but the lender etc grants out of it some form of subordinate right to income (e.g. a lease) to the lender etc., and the conditions in section 774A(2)(a) to (c) are met, it will be the case that section 774A(2)(d) is met, as the payments under the subordinate right will be payments under the arrangement by virtue of section 774F(3)(c) as the lender will be at least indirectly obtaining a benefit from the security.

17 Section 774B(3) which deals with the partnership borrower case looks through to the members of the partnership to see whether the income is charged to tax, brought into account in computing income or there is an entitlement to a deduction. This is because under UK tax law it is the members of a partnership who are charged to tax on their share of the profits of the partnership and the partnership itself is not treated as a taxable entity.

18 The consequence of the application of section 774B(1) is that the borrower etc. (including the members of a partnership) continues to be charged to tax as if the transaction was in form as well as in substance a loan, so that the transfer of the asset is treated as merely by way of security and the income from the security continues to be taxed on the borrower or, where the borrower is a partnership, the members.

19 Note that this rule has no consequence for and no effect on the lender etc. Both rent-factoring transactions and cases where section 774A etc is expected to apply involve lenders which are banks within the charge to corporation tax and so charged to tax on the interest element in the arrangement only under Chapter 2 Part 4 FA 1996 (see section 84 and 85A FA 1996) or are non-resident entities or otherwise exempt from UK tax.

20 In the “deduction” case, the remedy is to deny relief for the deduction: this is a similar approach to that in paragraph 1(5) to (8) Schedule 7 Finance (No. 2) Act 2005 (commencement rules for changes to rent factoring legislation in interposed lease cases), and, like those sub-paragraphs, is a simple surrogate for deeming the lender’s income to be the income of the borrower.

21 Section 774B(4) to (6) deal with the granting of relief to the borrower etc. for the interest element in the arrangement. Since the arrangement will involve the borrower paying more to the lender than it receives from the lender and this excess is in substance interest on the loan, the borrower should be entitled to relief for those amounts as if they were real interest. In the income deduction case this rule has the same effect as the limitation in paragraph 1(7) Schedule 7 Finance (No. 2) Act 2005 concerning the “principal in rent”.

22 Section 774B(4) deals with borrowers etc. who are persons within the charge to income tax and treats any amount recorded in the accounts as a finance charge as being an amount of interest payable on a loan. Where the receipts that are temporarily alienated under the SFA are trading receipts, the interest will be part of the deductions allowed under Chapter 3 Part 2 of the Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”): otherwise they may fall to be relieved in accordance with Part 9 ICTA.

23 Section 774B(5) deals with the company borrower case and in that case the advance under the arrangement is treated as a money debt owed by the company for the purposes of Chapter 2 Part 4 FA 1996 (loan relationships) and is treated in relation to the company borrower as a debtor relationship. Any amount shown in the accounts as a finance charge is treated as interest payable under that relationship. Section 774B(8) refers to this amount as “deemed interest”.

24 The relevance of the last provision is that the amount will become subject, where appropriate, to those rules in Chapter 2 which apply to interest such as paragraph 2 of Schedule 9. In order to give a rule as to the time of payment of the interest (relevant for that paragraph) section 774B(7) treats the payments under the SFA as divided into principal and interest with the interest element of each payment treated as paid when the payment is made.

25 Section 774B(6) provides that where relief is available for the finance charge in the case of a partnership, references to the accounts include the accounts of the partnership and amount treated as interest are treated as interest payable by the partnership, even if reflected in the accounts of the individual partner. In the corporate case this will mean that the provisions of paragraph 19 Schedule 9 FA 1996 apply to attribute the interest to the company partners in accordance with their shares and each partner will be subject to the provisions of Chapter 2 in relation to that part of the interest.

26 Section 774B(9) signpost the exceptions to the charge in section 774E.

The complex partnership case – sections 774C and 774D

27 New section 774C deals with the definitional aspects of the complex partnership case and provides that an arrangement is a structured finance arrangement in such a case, if either condition A or condition B is met.

28 Condition A is set out in section 774C(2) and requires that

- A person who the legislation calls the “transferor partner” disposes of an asset under the arrangement to a partnership which the legislation calls “the borrower partnership”.
- The borrower partnership is one of which the transferor partner is a member immediately after that disposal – it does not matter whether it was a partner before the disposal.
- Then the borrower partnership has to receive money or another asset which is called the advance, as in section 774A, from another person called the lender.
- The accounts of the borrower partnership have to record in accordance with GAAP a financial obligation in respect of the advance
- There is a relevant change in relation to the membership of the partnership involving the lender etc. (i.e. including a person connected with the lender). “Relevant change” is defined by section 774C(6).
- Finally, the share of the lender etc. in the profits of the borrower partnership falls to be determined (wholly or partly) by reference to payments in respect of the security.

29 Thus, in these types of arrangements, the lender’s advance is made in the form of a contribution to the partnership and its profit share is such that payments are made to it which repay that contribution together with interest. Once the repayment with interest has been made it is likely that there are arrangements under which the lender ceases to be a member of the partnership or to share in the profits of it.

30 Section 774C(3) makes it clear that any reference to the accounts of a borrower partnership, (to see if the accounts record a financial obligation) includes a reference to the accounts of any transferor partner.

31 See also section 774F(4) in connection with consolidated group accounts.

32 Section 774C(4) sets out condition B. This deals with a case where an existing partnership, rather than one established for the purposes of the arrangement, enters into an arrangement under which the lender becomes a

partner and shares in the profits to an extent sufficient to repay its contribution with interest. It differs from Condition A in that there is no reference to a transfer of an asset or a transferor partner.

33 Section 774C(5), which is the equivalent of section 774A(3), allows resort to the accounts of any person who was a member of the partnership before the arrangement to see if there is an accounting for the arrangement as a financial obligation.

34 Section 774C(6) provides that there is a “relevant change” in relation to the partnership membership for the purposes of section 774C and section 774D where, in connection with the arrangement, the lender etc. is either admitted to the partnership or receives a revised share of its profits.

35 Section 774C(7) provides that where in connection with the arrangements a person becomes connected with the lender, then that person is treated as connected with the lender for the purposes of section 774C(6).

36 New section 774D sets out the tax effects of a section 774C arrangement.

37 The primary requirement in section 774D(1) is that the section applies if the SFA is in relation to a partnership and there is a relevant change in relation to the membership of the partnership that would, apart from section 774D, have the “relevant effect” (set out in section 774D(2)).

38 What the relevant effect is depends on whether one of three conditions is met in relation to a “relevant member of the borrower partnership”. “Relevant member of the borrower partnership” is defined in section 774D(3) as being

- In a Condition A (section 774C(2)) case, the transferor partner
- In a Condition B (section 774C(4)) case, any member of the partnership immediately before the time at which a “relevant change” occurs (but does not include the lender).

39 The first condition, in section 774D(2)(a) is that an amount of income which would otherwise have been charged to tax on a relevant member is not so charged. This would cover cases where the income is “pure income profit”.

40 The second, in section 774D(2)(b), is that an amount which would otherwise been brought into account in calculating a relevant member’s income is not so brought into account.

41 This covers receipts which form part of the calculation of a profit whether of a trade, a property business or some other business.

42 The third, in section 774D(2)(c) is that a relevant member would have become entitled to an income deduction.

43 Section 774D(4) provides that both Part 9 of ITTOIA (income tax) and section 114 ICTA (corporation tax) are to have effect in relation to a relevant member of the borrower partnership as if the relevant change had not occurred so that, as section 774D(4) second sentence puts it, the SFA does not have the effect mentioned in subsection (2) of excluding the income from charge on, or allowing a deduction to, members of the borrower partnership.

44 Section 774D(5) to (7) deal with the relief for the finance charge in a Condition A case in a similar manner to section 774B(4) to (6) - but in the income tax case the finance charge is treated as interest payable by the transferor partner and in the corporation tax case the advance is treated for the purposes of paragraph 19 of Schedule 9 as a money debt owed by the borrower partnership and as a transaction for the lending of money and as interest payable by the transferor partner.

45 Section 774D(8) again provides that references to the accounts of the borrower partnership are to include the accounts of any transferor partner.

46 Section 774D(9) and (10) deal with the finance charge in a condition B case in a similar manner, but attribute the relief to any relevant member of the borrower partnership and not just the transferor partner. Section 774D(11) provides that references to the accounts of the borrower partnership include those of any relevant member.

47 Section 774D(12) replicates the rule in section 774B(7) for determining when the deemed interest is paid. Again, the payments made in respect of the security are treated as split between interest and repayment of principal, with the interest paid on the date that the payment is made.

48 Section 774D(13) defines the terms “deemed interest” in similar manner to section 774B(8).

49 Section 774D(14), as with section 774B(9), provides that the charging provision and the relieving provisions are subject to the exceptions in section 774E.

The exceptions

50 Section 774E then sets out those exceptions.

51 The first in section 774E(1) disapplies sections 774B or 774D if the whole of the advance is charged to tax as an amount of income, or brought into account in computing income or is brought into account under any provision of the Capital Allowances Act as a disposal receipt or the proceeds from a balancing event or disposal event. But it is not sufficient that the amount falls within the provisions of TCGA 1992.

52 Section 774E(2) identifies the person on whom the charge to income must arise before there is an exception and it is the person would not be charged to tax or would be allowed a deduction but for section 774B or section 774D.

53 Section 774E(3) makes it clear that in the case of the a capital allowances balancing charge, an advance is not to be treated as wholly brought into account if there is a restriction on the amount of that charge (for instance, the advance is greater than the expenditure which qualified for allowances so that, for example, section 62 Capital Allowances Act 2001 had effect).

54 Section 774E(4) excludes any arrangements which are repos or stock-lending arrangements because the tax treatment of that type of transaction is already provided for in a similar fashion and section 774E(5) excludes any arrangements which are alternative finance arrangements within the meaning of Chapter 5 Part 2 FA 2005.

55 It should be noted that these sections might possibly apply to certain types of alternative finance arrangements known as sukuks. But consideration is being given to making, in due course, regulations under Chapter 5 (see clause 98 of the Finance (No. 2) Bill 2006) to bring those arrangements within that Chapter and to give them the same tax treatment as is afforded by these sections.

56 Section 774E(6) to (8) give the Treasury a regulation making power to exclude any other cases and those excluding regulations are capable of having retrospective effect. Thus, if it were to be established once the legislation has been tabled that there is an exclusion which ought to be made, it could be made to have effect from the date from which 774A etc. have effect, even though the regulations themselves cannot be made until Royal Assent.

Minor definitions etc.

57 New section 774F provides a number of minor definitions for the other sections.

58 Section 774F(1) defines, in a boilerplate provision, that “arrangement” to include any agreement or understanding, whether it is legally enforceable or not.

59 Section 774F(2) defines “income deduction – see paragraph 15 above.

60 Section 774F(3) provides that receiving an asset or payments in respect of an asset, includes the obtaining the value of, or a benefit from, an asset, whether directly or indirectly (see paragraph 16 above), and it also provides that any reference to a disposal of an asset includes anything which is a disposal for the purposes of the Taxation of Chargeable Gains Act 1992 (“TCGA”). Thus it includes a part disposal (see section 21(2) TCGA) and the grant of a lease.

61 Section 774F(4) provides that the section 839 meaning of connected persons applies.

62 Section 774F(5) and (6) deal with accounting practice and accounts. References to accounts include the consolidated group accounts of a group of companies of which the relevant person is a member and in addition subsection (5) provides that if accounts are not drawn up in accordance with GAAP the sections apply as if they were. GAAP, in this case, includes both UK GAAP or International Accounting Standards – see section 50 FA 2004. In the case of UK GAAP it will often be FRS5 (accounting for the substance) which provides that a structured financing arrangement is accounted for as a financial obligation.

63 Section 774F(7) ensures that the lease premium rules in section 34 ICTA (including as applied to overseas leases by section 70A ICTA) (corporation tax) and sections 277 to 281 ITTOIA (income tax) do not apply in a case where a disposal of a security consists of the grant of a lease at a premium. Cf. section 43E(5) ICTA.

64 Sub-paragraphs (2) to (7) of paragraph 2 deal with commencement. The primary rule in sub-paragraph (2) is that the provisions of sections 774A to

774F inserted by sub-paragraph (1) have effect whenever any arrangement has been made.

65 They differ from, for example, the rent-factoring rules which applied to a transfer taking place on or after the relevant date. For the purpose of this paragraph it is irrelevant that any transfer of the security took place before the announcement, but sub-paragraph (3) goes on to provide that the effect of section 774B and 774D is only to charge to tax or bring income into account so far as it arises on or after 6th June.

66 Sub-paragraph (4) deals with the repeal of the rent-factoring legislation. Paragraph 1 of the Schedule repeals that legislation in relation to transactions entered into on or after 6th June 2006 and sub-paragraph (4) preserves the rent-factoring legislation in its application to transactions entered into before that date and provides that nothing in section 774A to 774D has effect on a rent-factoring arrangement within sections 43A to 43G ICTA.

67 Sub-paragraphs (5) to (7) deal with the loan relationships consequences where an arrangement is treated as a loan relationship by the new sections. A period of account for the purposes of Chapter 2 Part 4 FA 1996 is treated as beginning on 6th June 2006. The loan relationship itself is treated as having been entered into for a consideration equal to its notional carrying value and that is defined as the amount which would have been the carrying value in the accounts (carrying value with the meaning it has for paragraph 19A Schedule 9 FA 1996) if a period of account had ended immediately before the 6th June.

68 Paragraph 3 make a consequential amendment to section 785A of ICTA which deals with factoring of plant and machinery rentals. Section 785A is capable of having effect in relation to some types of SFA but a new section 785A(5A) ensures that section 774B or 774D have priority. That leaves section 785A applying in cases where the whole of the amount of relevant consideration falls within that section (as this would be a section 774E case).

69 Paragraph 4 make a consequential amendment to section 786 of ICTA which deals with transactions associated with loans or credit. Section 786(5) is capable of having effect in relation to some types of structured finance arrangements but a new section 786(5ZA) ensures that section 774B or 774D has priority.

70 Paragraph 5 inserts a new section 263E into the Taxation of Chargeable Gains Act 1992 to deal with the consequences of structured financing arrangements for the purposes of that Act.

71 Consistently with section 26 of that Act and with sections 263A to 263D, dealing with repos and stock-lending, section 263E(1) provides that the disposal of a security by the borrower etc. is disregarded for the purposes of TCGA. This disregard will apply in accordance with subsection (1), if section 774B applies to a SFA and there is a disposal of the security within the meaning of those sections to the lender etc. and conditions A or B are met.

72 Condition A is set out in section 263E(2) and is that under the arrangement the person making the disposal reacquires exactly the same asset.

73 Condition B is in section 263E(3) and is that the asset ceases to exist because, for example, it is a stream of income which expires once the “loan” has been repaid with interest, and the asset was held by the lender etc. until that time.

74 Subsection (4) goes on to provide that any subsequent reacquisition is also disregarded as long as it is made by the person who made the disposal.

75 Subsection (5) provides some definitions of terms used in it and gives them the same meaning as they have in section 774A onwards.

76 Sub-paragraphs (2) and (3) give the commencement. If the disposal is on or after the date of announcement, section 263E has effect automatically. If the disposal was made before the date of announcement then the section applies if a claim is made to that effect. If no claim is made in such a case, then the subsequent reacquisition is not disregarded.