# INTM551260: Hybrids: Financial instruments (Chapter 3): Example: Interest free loan – deemed discount

This example looks at situations where a company issues an interest free loan to a related company. The two companies use different accounting treatment for the deemed discount on the loan.

The example considers whether the deemed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Note - the accounting and tax treatment shown here is hypothetical, designed to illustrate the principles underlying the legislation

Co. 1 is a company resident in the UK
Co. 1 establishes a subsidiary, Co. 2, also in the UK 
Co. 1 provides Co. 2 with capital of 40, which consists of 5 share capital and 35 interest-free loan (the ‘Loan’)
The Loan is repayable in full at the end of the five years
The Loan is treated as a debt instrument under the laws of the UK
For the purposes of the example, it is assumed that applying local GAAP, which is assumed to be respected for tax, Co. 2 is required to split an interest free loan from its parent company (Co. 1) into two separate components: 
a loan of principal amount 35, which Co. 2 is treated as having issued to Co. 1 at a discount of 10, such that is initial carrying value is 25, and 
a deemed equity contribution equal to the amount of that discount (10). 


## Background

* Co. 1 is a company resident in the UK
* Co. 1 establishes a subsidiary, Co. 2, also in the UK
* Co. 1 provides Co. 2 with capital of 40, which consists of 5 share capital and 35 interest-free loan (the ‘Loan’)
* The Loan is repayable in full at the end of the five years
* The Loan is treated as a debt instrument under the laws of the UK
* For the purposes of the example, it is assumed that applying local GAAP, which is assumed to be respected for tax, Co. 2 is required to split an interest free loan from its parent company (Co. 1) into two separate components:
* a loan of principal amount 35, which Co. 2 is treated as having issued to Co. 1 at a discount of 10, such that is initial carrying value is 25, and
* a deemed equity contribution equal to the amount of that discount (10).
* The amount that Co. 2 treats as due for the interest free loan is based on an arm’s length valuation.
* The payee is not a relevant investment fund as defined in s259NA.

**Table 1**

**Co. 2 – Assets, Liabilities and Equity**

|  |  |
| --- | --- |
| Assets – Fixed assets | 40 |
| Liabilities – Shareholder loan | (25) |
| Equity:  Share capital  Other equity | 5  10 |

As is detailed in Table 1 above, Co. 2 has treated the interest free sum of 35 as an equity contribution of 10 and a loan whose initial carrying value is 25. In each accounting period Co. 2 will be required to accrue a portion of the deemed discount on the loan as an expense for accounting purposes and to treat this expense as funded out of Co. 1’s deemed equity contribution.

**Table 2** below provides a simplified illustration of how Co. 2 might account for the accrued liability under the shareholder loan as at the end of Year 1.

**Table 2**

|  |  |
| --- | --- |
| **Co. 2 – Assets, Liabilities & Equity** | **Co. 2 – Income** |
| **Asset 45**  Current assets (cash) 5  Fixed assets 40  **Liabilities 27**  Shareholder loan 27  Equity:  Share Capital 5  Other Equity 13 | **Income Tax Cash**  Operating income 5  **Expenditure**  Accrued liability on (2)  shareholder loan  **Net return 3** |

In this case Co. 2 treats the deemed discount as accruing at the implied internal rate of return of 8.0%, so at the end of Year 1 the shareholder Loan is recorded on the balance sheet as 27 (an increase of 2).

‘Other equity’ has subsequently been reduced by the 2, taken to the shareholder loan as the interest expense, and then increased by the 5, being the operating income received during the period.

For the purposes of this example, it is assumed that UK tax law permits this deemed increase in liabilities to be treated as a current expense in Year 1 so that, as Co. 2 has operating income of 5 in that year, its accounts show a net return of only 3 (that is, the income of 5 less the deemed increase in liabilities of 2 treated as a current expense).

Applying the same accounting treatment in each of the following years will permit the entire discount to be expensed over the life of the Loan so that, at maturity, the shareholder Loan will be recorded on the company’s balance sheet at its face value (35).

Co. 1 adopts different accounting standards from Co. 2 and under those standards it is not required to bifurcate the interest free Loan into equity and debt components.

Accordingly the accrued liability recorded in Co. 2’s accounts in each year is not recognised as income by Co. 1.

On repayment of the loan the entire amount paid by Co. 2 is simply treated as a non-taxable return of loan principal.

## Analysis - Applying the test in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

### Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

The Loan would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Co. 2 may claim a deduction against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach as Co. 2 – an assumption required by s259BB(4)(b). Therefore the accrued expense satisfies the definition of a quasi-payment within s259BB (2) TIOPA 2010.

Condition A is satisfied.

### Condition B: Is Co. 1 or Co. 2 within the charge to corporation tax?

The charge to corporation tax is the charge to corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

### Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this quasi-payment?

Given the background and assumed tax treatment above, it is reasonable to suppose the UK will permit Co. 2 a deduction (relevant deduction) for the accrued obligation under the loan against its ordinary income. It is also reasonable to suppose that the UK will not require Co. 1 to bring the corresponding amount into tax as ordinary income.

Therefore Case 1, as defined in s259CB (2), applies to characterise the quasi-payment as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the quasi-payment, arise to Co. 1 in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument – the mismatch arises because of the loan being interest free and between related parties.

Note: It is likely in this case that the Group Mismatch Scheme rules will also apply to address the mismatch ([CFM77500](https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm77500) refers), and that the unallowable purpose loan relationship rules or even possibly the transfer pricing rules would apply to deny the deduction in question.

### Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?

As Co. 1 owns all the shares in Co. 2 the companies are related as the conditions within s259NC TIOPA 2010 are satisfied.

Condition D is satisfied. There is no need to consider whether there is a structured arrangement.

### Conclusion

All the conditions are satisfied to characterise the arrangement involving the accruals of interest under the Loan as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, and the relevant counteractions need to be considered.

## Counteraction

Ordinarily, the counteraction applied will depend on whether the legislation is being applied to Co. 1 or Co. 2: in this case, however, since both companies are in the UK, the following applies:

### Counteraction to Co. 2 (the payer) (under s259CD TIOPA 2010)

#### Primary Response

The deductions claimed would be disallowed in Co. 2.

### Counteraction to Co. 1 (the payee) (under s259CE TIOPA 2010)

#### Secondary Response

As both companies are UK resident, both payer and payee are UK resident and therefore the primary counteraction under s259CD TIOPA 2010 would always apply, with the result that the mismatch would be counteracted in Co. 2.

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