

DEBTS AND CAPITAL GAINS TAX

This Help Sheet explains:

- **how debts are dealt with for Capital Gains Tax purposes**
- **how you may be able to claim an allowable loss if a loan you have made to a trader cannot be repaid**
- **how you may be able to claim an allowable loss if you have guaranteed a loan to a trader and have to pay up under the guarantee.**

This Help Sheet only explains the basic rules as they apply in simple cases. In more complex cases, you may need to obtain professional advice. Your Inland Revenue office will also be pleased to help and you can ask to see the Inland Revenue Capital Gains Manual, which explains the rules in detail.

WHAT IS A DEBT?

A debt exists whenever money is owed to someone else. A debt is an asset in the hands of the creditor or lender. That asset will be disposed of when the debt is repaid or if the lender sells or transfers the debt. But there are only a limited number of circumstances in which such a disposal gives rise to a chargeable gain or allowable loss.

A debt is not an asset but a liability in the hands of the debtor or borrower. Capital Gains Tax is concerned with the disposal of assets, not liabilities. Therefore a borrower will not make a chargeable gain or allowable loss from the disposal of a debt.

HOW ARE DEBTS DEALT WITH FOR CAPITAL GAINS TAX PURPOSES?

For Capital Gains Tax purposes, debts can be divided into three broad categories.

— Simple debts

A simple debt is a straightforward loan or amount owing by one person to another. Simple debts are not chargeable assets in the hands of the original lender. But you may be able to claim a loss if a loan you have made to a trader cannot be repaid. Please see 'Losses on loans to traders' in the next column.

It is possible to buy debts. A debt will be a chargeable asset if you are not the original lender. But a loss on the disposal of a simple debt, by a person who is **not** the original lender, may not be allowable for Capital Gains Tax purposes. Ask your Inland Revenue office or tax adviser for details.

— Securities

Securities are more formal loans made to companies. Securities are chargeable assets in the hands of the original lender. But many securities are exempt from Capital Gains Tax because they are qualifying corporate bonds (QCBs). If you buy or subscribe for listed securities, your broker or the company should be able to tell you whether they are QCBs. There are also published lists showing which listed securities are QCBs. Your Inland Revenue office has copies of these lists.

If you acquired the QCB on a company share reorganisation or take-over there may be a chargeable gain or allowable loss on disposal. Further information is in *Help Sheet IR285: Share reorganisations, company take-overs and Capital Gains Tax* in the section on company take-overs and Capital Gains Tax.

Loans made to unlisted companies may also be securities and QCBs. This can be a complex subject; ask your Inland Revenue office or tax adviser for help.

— Gilt-edged securities

Gilt-edged securities, or 'gilts', are UK Government securities issued by the Treasury. Gilts are exempt from Capital Gains Tax.

LOSSES ON LOANS TO TRADERS

If you make a loan to a trader you may be able to claim an allowable loss if the loan cannot be repaid. The loan must have been used for a trade purpose and have become irrecoverable.

Example 1

You lend £30,000 to your brother to start a bicycle shop. After trading successfully for a number of years, the business fails. £5,000 of the loan is repaid to you, but £25,000 is irrecoverable. You can claim an allowable loss of £25,000.

If you claim the relief, you will be taxable on any amounts of the loan subsequently repaid.

Example 2

Continuing Example 1, two years after you make the claim your brother is able to repay £10,000. You are treated as having made a capital gain of £10,000 in the tax year in which the £10,000 is repaid.

WHAT LOANS QUALIFY?

To qualify for relief the loan must be to a borrower who:

- is resident in the UK, **and**
- uses the money for the purposes of a trade, **or**
- who uses the money to set up a trade, as long as they start trading.

A trade includes a profession or vocation, but does not include money-lending. If the loan is made to a company, that company can pass the money to another company in the same group, to be used in that other company's trade.

Loans include credit balances on a director's loan account but not ordinary trade debts. Exceptionally, trade debts may qualify for relief if there is a specific agreement to extend the period of credit beyond what is customary for the trade concerned. But you cannot claim an allowable loss if you have claimed the bad debt as a trading expense.

The loan must not be a security, (see 'How are debts dealt with for Capital Gains Tax purposes' on page 1). If the loan is a security but not a QCB, the ordinary rules of Capital Gains Tax will allow you to claim an allowable loss if the loan becomes worthless. If the loan is a QCB, you may be able to claim a separate relief. Ask your Inland Revenue office for details.

DOES THE LOAN STILL HAVE TO EXIST WHEN CLAIMS ARE MADE?

Yes. Relief is only due if an amount of the loan is outstanding at the date you make the claim. You cannot claim relief if you have waived the loan or converted it into shares before making the claim.

WHAT DOES 'IRRECOVERABLE' MEAN?

Relief is only due if the loan has become irrecoverable. This does not mean merely that the borrower cannot repay the loan at the date you make the claim. You have to show that there was no reasonable prospect of the loan ever being repaid. If the borrower continues to trade, this test is unlikely to be satisfied.

The loan must have **become** irrecoverable. Relief will not be due if the loan was irrecoverable when it was made. If you make a claim shortly after making the loan, this may cast doubt on whether the loan was ever recoverable.

The loan must not have become irrecoverable as a result of the terms of the loan or some act or omission by the lender.

HOW IS THE RELIEF GIVEN?

The relief is given by treating the irrecoverable loan as an allowable loss. Normally you cannot claim that part of a loan that has become irrecoverable. But you **can** make a claim for the outstanding balance of a loan if:

- the borrower has been placed in bankruptcy, receivership or liquidation, **and**
- the receiver or liquidator has announced an anticipated dividend in respect of unsecured debts and has indicated that no further dividends are likely.

Example 3

You have lent £10,000 to a company. The company goes into liquidation. The liquidators say they hope to make a payment of 20p in the pound to unsecured creditors but there will be no further payments. You may claim an allowable loss of £8,000.

HOW TO MAKE A CLAIM. ARE THERE ANY TIME LIMITS?

After the loan has become irrecoverable there is no time limit in which to make the claim. But remember the loan must still exist at the time you make the claim. The loss will arise:

- at the time you make the claim **or**, if you want,
- at an earlier time you specify when you make your claim that falls in either of the two previous tax years, provided all the necessary conditions for relief are satisfied at the date you make the claim **and** at the earlier time.

So, if you make a claim during the tax year 2000-2001, the loss will have arisen in 2000-2001. Alternatively you can ask for the loss at an earlier time specified in your claim that falls during 1998-99 or 1999-2000, provided all the necessary conditions for relief were also satisfied then.

If you want to make a claim for 2000-2001, write giving details of your claim to your Tax Inspector.

If you want to make a claim for 1999-2000 in your Tax Return for 1999-2000, you should provide details of the claim (including details of the earlier time at which relief is sought) in column G, and include the loss in box 8.2 of your Capital Gains Pages.

In the tax year 2000-2001 you can also ask for the loss to be given at a time falling in 1998-99 by amending your 1998-99 Tax Return on or before 31 January 2001. If you decide to ask for the carry back to 1998-99, at some time between 1 February 2001 and 5 April 2001 you will have to send the Tax Inspector a separate notice.

WHAT HAPPENS IF YOU RECOVER THE LOAN?

If you recover any amount for which you have claimed relief, the amount you receive is treated as a chargeable gain. The chargeable gain arises in the tax year the payment is received. If you received any such payments in 1999-2000, the amount should be added to other chargeable gains, and entered in box 8.1 of the Capital Gains Pages.

RELIEF FOR PAYMENTS MADE UNDER GUARANTEES GIVEN ON BEHALF OF TRADERS

Instead of making a loan to a trader yourself you may act as guarantor for a loan. If the loan, or the interest on it, becomes irrecoverable, and you have to pay up under your guarantee, you may claim an allowable loss. The relief will be reduced by any amounts payable by co-guarantors. The conditions for relief are very similar to those which apply to losses on loans to traders.

Example 4

Your brother borrows £20,000 from the bank to set up a bicycle shop. You provide a personal guarantee for the loan. After a period of trading successfully the business fails. The loan cannot be repaid. The bank calls on you to pay £20,000 under the guarantee. You can claim an allowable loss of £20,000 in the year the payment is made.

WHAT ARE THE CONDITIONS FOR RELIEF?

The guarantee must be made in respect of a loan which satisfies all the conditions set out under 'What loans qualify?' on page 1. The only difference is that relief can be given for a guarantee of a loan which is a security.

Some part of the loan or the interest on the loan must be outstanding at the date of the guarantee payment. This amount must be irrecoverable from the borrower.

HOW IS THE RELIEF CALCULATED?

The amount you pay under the guarantee will be treated as an allowable loss. But the amount of relief will be limited if you are entitled to receive any payments from co-guarantors. This restriction is not limited to amounts you actually receive from co-guarantors. However, you must take account of their ability to pay. If a co-guarantor is unable to make a payment, the liability of the other guarantors will be increased accordingly. If you think this restriction applies, you should ask your Inland Revenue office or tax adviser for advice. On the other hand, you can claim relief for amounts you have to pay as a co-guarantor.

HOW TO MAKE A CLAIM

The appropriate proportion of the payment is treated as an allowable loss for the year in which the payment is made.

If you make a guarantee payment in 1999-2000, you should provide details of the claim in column G, and include the allowable loss in box 8.2 on Page CG3 of the Capital Gains Pages.

The claim has to be made within six years of 31 January in the year in which you make the payment under the guarantee.

WHAT HAPPENS IF ANY PART OF THE AMOUNT PAID IS RECOVERED?

If, after you have made a claim, you recover any amount of the loan or interest, or any part of the guarantee payment, the amount you receive is treated as a chargeable gain. The chargeable gain arises in the year the payment is received. If you have received such a payment in 1999-2000, the amount should be included with any other gains and entered in box 8.1 of the Capital Gains Pages.