

## **Part 6: Loan Relationships**

### ***Overview***

1. This overview deals with Parts 6 and 7.
2. This and the following Part contain provisions on loan relationships. The considerable extent of the legislation merits two Parts.
3. A company has a loan relationship when it stand as a creditor or debtor in respect of a money debt which is a transaction for the lending of money. The rules dealing with loan relationships are rewritten in Part 6. Part 6 is based mainly on Chapter 2 of Part 4 of FA 1996, which brings into account for corporation tax purposes all gains and losses arising to a company from its loan relationships.
4. Other arrangements which are brought into loan relationships such as debt which does not involve the lending of money, alternative finance arrangements that are compliant with Shari'a law, particular share issues, repurchase agreements etc are rewritten in Part 7. The source legislation for this Part is sometimes found outside FA 1996. The loan relationship aspects of some provisions are still being considered for inclusion, for example section 488 of ICTA (co-operative housing associations).
5. Gains on loan relationships that are used for the purposes of a trade are charged under Schedule D Case I. The charge on such gains falls within the Trading Income Part of this Bill, although the computational rules are within Part 6. Losses on loan relationships that are used for the purposes of a trade are likewise treated as trading losses. Gains on loan relationships that are not used for the purposes of a trade are charged under Schedule D Case III and the charge in this Bill is in Part 6.
6. Gains on derivative contracts which are not used for the purposes of a trade are charged as if they were gains on loan relationships and the charge is therefore within this Part of the Bill also although the rules on computing such profits are to be found in the Derivative Contracts Part of this Bill. Losses on such derivatives are also dealt with as if they were losses on a loan relationship.
7. Provisions within the loan relationships regime applicable only to life insurance companies, whether within Schedule 11 to FA 1996 or elsewhere, may not be rewritten within these two Parts. As a general principle life insurance taxation will probably not be rewritten within this Bill although some flexibility may be applied where it is difficult to exclude minor rules.
8. Matters affecting TCGA 1992 have not been included within these Parts either.
9. Chapter 7 of Part 7 deals with manufactured payments and repos. At present this includes only the rewrite of section 97 of FA 1996. Paragraph 15 of Schedule 9 to FA 1996, as amended by Finance Bill 2007, and Schedule 13 of Finance Bill 2007 will later be included.

## **Chapter 1: Introduction**

### **Overview**

10. This Chapter acts as an introduction to the loan relationships Part. It sets out the structure of the Part, the main boundaries between this and other Parts of this Bill (and some provisions outside this Bill) and also provides definitions of frequently-used terms.

### **Clause 1: Overview of Part**

11. This clause provides an overview of the Part. It is new.

12. *Subsection (1)* refers only to “gains” on a loan relationship and not “profits and gains” as does the legislation. This has been followed throughout the Part on the ground that only one term is necessary. “Gains” as been adopted as being the usual accounting term for positive amounts. In the Accounting Standards Board’s “Statement of Principles for Financial Reporting” “gains” are defined as “increases in ownership interest not resulting from contributions from owners” and thus refers to both the profits on realisation of assets and the revenues derived by exploiting those assets.

13. The use of “gains” also follows the treatment in the intangible fixed assets legislation in Schedule 29 to FA 2002.

14. “Losses” has been used in place of “deficits” as the usual accounting term.

15. *Subsection (4)* provides that gains and losses from loan relationships include gains and losses from related transactions to prevent the current repetition.

16. The term “loan relationship” has been retained for its familiarity although the term is not as appropriate now as it was when the legislation was enacted in 1996. The provisions now apply to a number of relationships which are not “loans”.

<p><b>Q1. We welcome views on whether the term “loan relationships” should be retained and, if not, suggestions for a new term.</b></p>
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### **Clause 2: Relationship of Part 7 and this Part**

17. This clause requires references to this Part of Bill 5 to include references to Part 7. This arises from the decision to spread the loan relationships provisions over two Parts of the Bill. It is new.

### **Clause 3: Amounts brought into account under this Part excluded from being otherwise brought into account**

18. This clause provides the main boundary provision applying to loan relationships. The clause is based on section 80(5) of FA 1996.

**Clause 4: Interest only deductible in accordance with this Part**

19. This clause provides that no deduction of interest is allowed for corporation tax purposes other than under this Part. The clause is based on section 337A(2) of ICTA.

**Clause 5: Relationship of this Part to Part [3]**

20. This clause cross-refers to clause 14(2) which provides that gains on loan relationships used for the purposes of a trade are part of the trading profits. The clause is based on section 80(2) of FA 1996 and is new.

**Clause 6: Relationship of this Part to Part [8]**

21. This clause gives the boundary provision with Part 8 (derivative contracts) where a profit or loss could fall into either Part. The clause is based on section 101(1) of FA1996.

22. *Subsection (2)(b)* provides for the possibility that the amount brought into account under this Part will not be exactly the same as the amount brought into account under Part 7.

**Clause 7: Exclusion of distributions**

23. This clause excludes distributions from being brought into account under this Part. It is based on paragraph 1(1) and (2) of Schedule 9 to FA 1996 and is new.

24. Where interest on a security falls within the definition of a distribution under section 209 of ICTA that distribution will not therefore be brought into account under this Part.

**Clause 8: Exclusion of amounts relating to life assurance policies**

25. This clause excludes amounts on life assurance policies from being brought into account under this Part. The clause is based on paragraph 1A(1) and (2) of Schedule 9 to FA 1996.

**Clause 9: Meaning of “loan relationship”, “creditor relationship”, “debtor relationship” etc**

26. This clause defines three important terms used in this Part. The clause is based on section 81(1) and 103(1) of FA 1996 and is new.

**Clause 10: Meaning of “money debt”**

27. This clause defines “money debt” for the purposes of the definition of a loan relationship in clause 9. The clause is based on section 81(2) to (4) of FA 1996.

28. Section 81(6) which states that “money” includes money expressed in a currency other than sterling has not been rewritten as unnecessary. “Money”, in its usual meaning, already includes currencies other than sterling.

**Clause 11: Meaning of payments, interest, rights and liabilities under a loan relationship**

29. This clause explains what is meant by payments and interest under a loan relationship. The clause is based on sections 81(5) and 84(5) and (6) of FA 1996.

**Clause 12: Meaning of “related transaction”**

30. This clause explains what is meant by “related transaction”. The clause is based on section 84(5) and (6) of FA 1996.

**Chapter 2: Method of taxation**

**Overview**

31. This Chapter charges to corporation tax gains on loan relationships if the loan relationship is not for the purposes of the trade. It is based on sections 80 and 82 of FA 1996.

**Clause 13: Introduction**

32. This clause acts as a general introduction to the Chapter and is new.

**Clause 14: Method of bringing gains into account**

33. This clause provides that gains on loan relationships must be brought into account for tax purposes under the rules of this Chapter. In particular it provides that where a company is party to a loan relationship for the purposes of a trade the gains from that relationship, computed under the rules of this Part, form part of the trading profits. The clause is based on sections 80(2) and (3) and 103(2) and (3) of FA 1996.

**Clause 15: Method of bringing losses into account**

34. This clause explains how losses on loan relationships are brought into account and is based on section 80(4) of FA 1996.

**Clause 16: Profits and expenses of trades from loan relationships: trading credits and debits**

35. This clause explains how debits and credits are to be treated where a loan relationship is used for the purposes of a trade. It is based on section 82(1), (2) and (7) and is new.

36. The clause references in subsection (4) are to clauses 22, 23 and 40 respectively of the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

**Clause 17: Charge to tax on gains from non-trading loan relationships**

37. This clause gives the charge to tax on gains from loan relationships which are not used for the purposes of a trade. It is based on sections 9(2B) and 18 of ICTA and 80(1) of FA 1996. See comments and question under clause 170 in relation to *Change I* in Annex 1.

**Clause 18: Income charged to tax under section 17**

38. This clause charges the full amount of gains arising in the accounting period and is based on section 70(1) of ICTA.

**Clause 19: Calculation of gains and losses from non-trading loan relationships: non-trading credits and debits**

39. This clause explains the use of the terms “non-trading credits” and “non-trading debits” in respect of loan relationships which are not used for the purposes of a trade. It is based on section 82(1) and (3) to (6) of FA 1996 and is new.

**Chapter 3: The credits and debits to be brought into account: general**

*Overview*

40. This Chapter deals with a number of matters related to the debits and credits to be brought into account, in particular accounting matters. The provisions in this Chapter all represent basic rules that apply generally rather than to specific types of securities or specific types of companies. They have therefore been placed early on in the Part.

**Clause 20: Overview of Chapter**

41. This clause provides an overview of the Chapter and explains the purpose of the clauses within the Part and signposts other relevant Chapters. It is new.

**Clause 21: General principle for credits and debits: amounts fairly representing gains and losses**

42. This clause provides the rule that credits and debits must fairly represent gains and losses from loan relationships and also gives further rules on allowable expenses. The clause is based on section 84(1) and (3) and is new.

43. “Interest” in section 84(1)(b) is not specifically rewritten in this clause as it is beyond doubt that interest is a gain arising from a loan relationship.

44. This clause has not rewritten the words “including those of a capital nature” in section 84(1)(a) because the older distinction between capital and revenue is no longer relevant for accounting gains. If the distinction is relevant for the loan relationship Parts the provision will specifically refer to capital payments (eg clauses 96 and 97 which are signposted in *subsection (5)*).

45. *Subsections (2)(b) and (3)* allow certain expenses on loans to be treated as debits under the loan relationship provisions. See the commentary on clause 151 regarding the incidental costs of issuing shares in a building society.

**Clause 22: Pre-relationship expenses where relationship not entered into**

46. This clause allows abortive expenses in connection with a loan relationship. The clause is based on section 84(4) of FA 1996.

47. The word “sums” in section 84(1) of FA 1996 is rewritten as “amounts” for consistency with the remainder of Chapter 2 of Part 4 of FA 1996 and this Part.

**Clause 23: Exchange gains and losses from loan relationships**

48. This clause includes exchange gains and losses within credits and debits on loan relationships. The clause is based on section 84A(1) to (3A) and (8) to (10) of FA 1996.

49. *Subsection 3(b)(i)* rewrites “statement of recognised gains and losses” as “statement of total recognised gains and losses” as being the usual accountancy term.

50. Section 84A(9)(b) of FA 1996 has not been rewritten as being a TCGA matter.

51. Section 70 of F(No.2)A 2005 repeals section 84A of FA 1996 with effect from a date to be appointed.

**Clause 24: Generally accepted accounting practice and recognised amounts**

52. This clause provides the link between the debits and credits to be taken into account and the company’s accounts. Those debits and credits are those that are recognised in determining profits under generally accepted accounting practice (GAAP). The clause is based on sections 85A(1) and 85B(1) and (2) of FA 1996.

53. *Subsection (2)* brings out the meaning of “amounts” in section 85A(1).

54. Accounting terms appearing more than once have been included in clause 151 (other definitions). “Profit or loss account” (*subsection (4)*) and “prior period adjustment” (*subsection (5)*) appear here only and will take their ordinary accountancy meaning.

55. “Generally accepted accounting principles” appears in the index of this Bill.

56. *Subsection (4)(b)* rewrites “statement of recognised gains and losses” as “statement of total recognised gains and losses” as being the usual accountancy term.

57. Section 70 of F(No.2)A 2005 repeals section 85B of FA 1996 with effect from a date to be appointed.

**Clause 25: Companies without GAAP-compliant accounts: meaning of “amounts recognised for accounting purposes”**

58. This clause gives the rule to be applied where accounts have not been prepared in accordance with generally accepted accounting standards. The clause is based on section 85A(2) and (3) of FA 1996.

59. “Correct accounts” in section 85A(2) has been rewritten as “GAAP-compliant accounts” in *subsection (1)* as being a more neutral term.

**Clause 26: Power to make regulations about accounts**

60. This clause gives powers to make regulations affecting clause 24. It is based on section 85B(3) to (6) of FA 1996.

**Clause 27: Amounts not fully recognised for accounting purposes: introduction**

61. This and the following clause apply where, as a result of GAAP, the full amount arising on transactions is not brought into account. This arises where assets and liabilities are “matched” and GAAP permits the whole or part of the income arising on those assets to be “derecognised”. These two clauses provide that where an interest receipt is matched with certain payments the two must be separated and relevant taxation treatment applied to both. This clause sets out the circumstances in which clause 28 applies. The clause is based on section 85C(1) and (2) of FA 1996.

**Clause 28: Determination of credits and debits where amounts not fully recognised for accounting purposes**

62. This clause gives the rule to be applied where the circumstances in the preceding clause are in point. The clause treats the credits and debits arising on the transactions which are not recognised in determining the company’s profit or loss. The clause is based on section 85C(3) to (8) of FA 1996.

**Clause 29: Basis of accounting: “amortised cost basis”, “fair value accounting” and “fair value”**

63. This clause deals with the accounting bases that may apply to loan relationships. The clause is based on section 85A(1) and section 103(1) of FA 1996 and is new.

64. In general a company may make use of either an amortised costs basis or fair value in accounting for loan relationships (both these terms are defined in the clause) but certain provisions specify that an amortised cost basis must be used. These are listed in *subsection (2)*.

**Clause 30: Power to make regulations about changes from amortised cost basis to fair value accounting**

65. This clause provides the powers for the Treasury to make regulations providing for the continued use of an amortised costs basis. The clause is based on section 90A(1) and (2) of FA 1996.

**Clause 31: Introduction to sections 32 to 35**

66. This clause acts as an introduction to the following four clauses which provide the rules to apply where there is a change in accounting policy from one accounting period to the next.

67. Although this provision was enacted specifically to deal with companies changing from UK GAAP to international accounting standards or *vice versa* it will apply equally to other changes where both policies accord with the law and practice. The clause is based on paragraph 19A(1) and (2) of Schedule 9 to FA 1996.

**Clause 32: Adjustments on change of accounting policy involving change of value**

68. This clause requires debits or credits to be brought into account representing the difference between the value of the asset or liability at the end of the last period of account under the old accounting policy and the beginning of the first period under

the new accounting policy. The clause is based on paragraph 19A(3) and (5) of Schedule 9 to FA 1996.

**Clause 33: Meaning of “accounting value” and “carrying value”**

69. This clause gives the meaning of terms used in the previous clause. The clause is based on paragraph 19A(4A) and (4B) of Schedule 9 to FA 1996.

70. The reference to Schedule j3 in *subsections (1) and (5)(n)* is to Schedule 2 (transitionals and savings etc) of Bill 5.

71. Subsection (5)(e), which rewrites the reference in paragraph 19A(4B)(d) of Schedule 9 to section 94A(2) of FA 1996, will eventually include a reference to the Derivative Contracts Part when the remainder of section 94A(2) (see clause 116) is rewritten in that Part.

**Clause 34: Change of accounting policy: cessation of loan relationships**

72. This clause provides for debits and credits representing differences in value of assets and liabilities following a change of accounting policy to be brought into account where clause 45 (company ceasing to be party to a loan relationship) also applies. The clause is based on paragraph 19A(4C) to (5) of Schedule 9 to FA 1996.

**Clause 35: General power to make further provisions about changes in accounting policy by regulation**

73. This clause gives the Treasury powers to make regulations providing for debits and credits to be brought into account or not to be brought into account under this Part where a change of accounting policy affects the amounts brought into account for accounting purposes. The clause is based on paragraph 19B of Schedule 9 to FA 1996.

**Clause 36: Credits and debits treated as relating to capital expenditure**

74. This is the first of ten clauses which require debits and credits to be brought into, or not brought into, account for the purposes of this Part where normal accounting treatment is not followed. This clause provides that a credit or debit which has been capitalised but which is in respect of a loan relationship is, in certain circumstances, to be brought into account in arriving at the company’s profit or loss. The clause is based on paragraph 14 of Schedule 9 to FA 1996.

75. The words “for the purposes of corporation tax” in paragraph 14(2) have been rewritten in *subsection (2)* more narrowly as “for the purposes of this Part”, the wider purpose being unnecessary in this context.

**Clause 37: Credits and debits recognised in equity or shareholders’ funds**

76. This clause provides that credits and debits on loan relationships taken directly to reserves should be brought into account as if they were taken to the profit and loss account. The clause is based on paragraph 14A of Schedule 9 to FA 1996.

**Clause 38: Release of debts: cases where companies not required to bring credit into account**

77. This clause provides that credits are not brought into account by a debtor company when an amortised cost basis is used and certain conditions are met. The clause is based on paragraph 5(3), (4), (7) and (8) of Schedule 9 to FA 1996.

78. Conditions 2 and 3 of paragraph 5 of Schedule 9 to FA 1996 apply only where the debtor and creditor companies are connected and are rewritten in Chapter 6 of this Part (connected companies relationships: impairment losses and releases of debts).

79. *Subsection (6)* lists the insolvency conditions from paragraph 6A(1) of Schedule 9 to FA 1996 rather than cross-referring as does paragraph 5(7).

**Clause 39: Meaning of expressions relating to insolvency etc**

80. This clause gives the meaning of various terms relevant to the preceding clause. It is based on paragraphs 5(7) and 6A(3) to (5) of Schedule 9 to FA 1996.

81. References to “Part 3 of the Insolvency (Northern Ireland) Order 1989” in paragraph 6A(4)(b) of Schedule 9 have been updated to refer to Schedule B1 to that Order to reflect amendments made by the Insolvency (Northern Ireland) Order 2005 (SI 1989/2405 (NI19)).

**Clause 40: Restriction on debits resulting from revaluation**

82. This clause precludes debits from being brought into account for the purposes of this Part (other than impairment losses or debt releases on the revaluation of asset) unless under fair value accounting. The clause is based on paragraph 6D(1) and (3) to (5) of Schedule 9 to FA 1996.

**Clause 41: Restriction on credits resulting from reversal of disallowed debits**

83. This clause provides that the reversal of debits disallowed under the previous clause are not brought into account under this Part. The clause is based on paragraph 6D(2) and (5) of Schedule 9 to FA 1996.

84. The reference in *subsection (3)* to Schedule j3 is to Schedule 2 (transitionals and savings etc) of Bill 5.

**Clause 42: Writing off government investments**

85. This clause provides that no credit need be brought into account where the government releases a liability on a government debt. It is based on paragraph 7 of Schedule 9 to FA 1996.

**Clause 43: Disallowance of imported losses etc**

86. This clause ensures that no part of a loss on a loan relationship is brought into account if it arose at a time when the loan relationship was not subject to United Kingdom taxation. The clause is based on paragraph 10 of FA 1996.

**Clause 44: Debits in respect of pre-trading expenditure**

87. This clause provides for an election to be made for non-trading debits incurred before the commencement of a trade to be treated as trading debits after that trade has commenced. The clause is based on section 401(1AB) and (1AC) of ICTA.

**Clause 45: Company ceasing to be party to loan relationship**

88. This clause provides for debits and credits to be taken into account in respect of a loan relationship to which a company is no longer a party if those debits and credits have not already been fully taken into account. The clause is based on section 103(6) to (8) of FA 1996.

**Clause 46: Company ceasing to be UK resident**

89. This clause provides that a company ceasing to be resident in the United Kingdom is treated as disposing of assets and liabilities which represent loan relationships at fair value unless they are held or owed by a United Kingdom permanent establishment. The clause is based on paragraph 10A(1) to (3) of Schedule 9 to FA 1996.

**Clause 47: Non-UK resident companies ceasing to hold loan assets and liabilities for permanent establishment in UK**

90. This clause provides for a deemed disposal for fair value where an asset or liability representing a loan relationship of a non-United Kingdom resident company ceases to be held or owed by a United Kingdom permanent establishment other than as a result of a disposal etc. The clause is based on paragraph 10A(1), (1A) and (4) of Schedule 9 to FA 1996.

**Chapter 4: Continuity of treatment: groups and SE mergers**

*Overview*

91. This Chapter sets out what happens in respect of a transfer of loan relationships between members of a group and mergers of companies which give rise to an SE.

**Clause 48: Group member replacing another as party to loan**

92. Under this clause any gain or loss is disregarded where, as a result of a transaction or series of transactions, one group company replaces another as a party to a loan relationship. The clause provides that the transaction or series of transactions take place at book value (“carrying value”). The clause is based on paragraph 12(1), (2), (2C) and (9) of Schedule 9 to FA 1996.

93. The rules in this clause regarding the bringing into account of debits and credits apply only where the company being replaced as party to the loan relationship accounts for the relationship under the amortised cost basis. Clause 51 provides rules for where the company being replaced as a party to the loan relationship uses fair value accounting.

**Clause 49: Transactions to which section 48 applies**

94. This clause explains the meaning of transaction or a series of transactions for the purposes of clause 48. The clause is based on paragraph 12(1) and (8) of Schedule 9 to FA 1996.

**Clause 50: Meaning of companies replacing each other as parties to loan relationships**

95. This clause explains what is meant by one party replacing the other as a party to a loan relationship for the purposes of clause 48. *Subsections (2) and (3)* deal with the position where a company replaces another company as a creditor and *subsections (4) and (5)* where it replaces the other company as a debtor. The debtor rules will apply where a company has borrowed money but substitutes another group company as the debtor by novating the debt. The clause is based on paragraph 12(6) to (7A) of Schedule 9 to FA 1996.

**Clause 51: Exception to section 48: transferor using fair value accounting**

96. This clause applies where the company making the transfer under clause 48 uses fair value accounting as respects the loan relationship or the debits and credits to be brought into account rather than the amortised cost basis. The company which is being replaced as a party to the loan relationship brings in the asset or liability at fair value. The company becoming a party to the loan relationship is treated as acquiring the asset or liability for the same value as in the accounts of the company being replaced. The clause is based on 12(2A) to (2C) of Schedule 9 to FA 1996.

**Clause 52: Transferee leaving group after replacing transferor as party to loan relationship: introduction**

97. This clause introduces the two following clauses and provides that they apply where a company within a group to which an asset or liability has been transferred under clause 48 leaves the group within six years. The clause is based on paragraph 12(1), (5) and (8) of Schedule 9 to FA 1996.

**Clause 53: Replacement of transferor otherwise than because of exempt distribution**

98. This clause provides the first of the degrouping rules: where a company ceases to be a member of a group otherwise than as a result of an exempt distribution under section 213(2) of ICTA 1988. (Because section 213 of ICTA is designed to facilitate mergers there is no degrouping charge where that section applies to exempt a distribution of the company's shares.) The clause deems there to have been a disposal and reacquisition at market value just before the company leaves the group and any resulting credit is brought into account. The clause is based on paragraph 12A(2) to (5) and (8) and (9) of Schedule 9 to FA 1996.

99. *Subsection (4)* is designed to ensure parity of treatment between a loan relationship and a derivative contract that is being used to hedge it. The effect is to allow a debit on the loan relationship on deemed disposal if a credit is brought into account on the derivative contract.

**Clause 54: Replacement of transferor because of exempt distribution**

100. This clause applies to bring in a charge, in certain circumstances, where one group member replaces another group member as a party to a loan relationship and ceases to be a group member as a result of an exempt distribution under section 213(2) of ICTA 1988. Where a company exploits a demerger for avoidance purposes by transferring within a five year period funds or assets to its members, a chargeable payment arises under section 214(2) of ICTA. Where such chargeable payments are made this clause treats the company as disposing of, and immediately reacquiring, the loan relationship at fair value when the chargeable payment is made. The clause is based on paragraph 12A(3) to (9) of Schedule 9 to FA 1996.

**Clause 55: Formation of SE by merger: disregard of incidental transfers of loan relationships**

101. This clause allows transfers of loan relationships to be disregarded, other than for exchange gains and losses, where they take place as a result of a merger of two or more companies to form an SE liable to United Kingdom corporation tax. The clause is based on paragraph 12B(1) to (3) and (7) of Schedule 9 to FA 1996.

102. The proposed definition of “SE” for this Bill is “a European public limited-liability company (or Societas Europaea) within the meaning of Council Regulation (EC) No 2157/2001 on the Statute for a European company”.

**Clause 56: Exception to section 55: transferor company using fair value accounting**

103. Where the company transferring the loan relationships uses fair value accounting either in respect of the loan relationship or the debits and credits to be brought into account under this Part, this clause applies to ensure that the transfer takes place at fair value and that the company acquiring the loan relationship does so for the same value. The clause is based on paragraph 12B(4) of Schedule 9 to FA 1996.

**Clause 57: Exception to section 55: tax avoidance etc**

104. This clause provides that clause 55 will not apply if the merger to form an SE takes place for reasons of tax avoidance. It is based on paragraph 12B(5) and (6) of Schedule 9 to FA 1996.

**Chapter 5: Connected companies relationships: introduction and general**

*Overview*

105. Connected companies loan relationships are subject to special rules under this Part. The Chapter explains what is meant by such a relationship, the accounting rule to apply to that relationship and what happens when a company begins or ceases to be a connected company.

**Clause 58: Introduction: meaning of “connected companies relationship”**

106. This clause provides the meaning of “connected companies relationship” – broadly where the debtor and creditor of a loan relationship are connected companies,

either directly or via a series of loan relationships linking the two connected companies. The clause is based on section 87(1) and (5) of FA 1996.

107. “Person” in section 87(1), (3) and (5) has been rewritten as “company”. See *Change 2* in Annex 1.

**Q2. We welcome comments on the proposal to rewrite “person” as applying only to a company.**

108. Section 87(5) deals with intermediaries between two connected companies through which a loan is dog-legged. Such intermediaries may be individuals. This has been rewritten in *subsections (3) and (4)* of this clause by separating debtor and creditor relationships. Paragraph (b) of these subsections is necessary because loans between individuals do not fall into the definition of a loan relationship in section 81(1) of FA 1996.

109. *Subsection (6)* brings out more clearly than in the source legislation (section 87(3) of FA 1996) that where there is a connection at any time in an accounting period there is a connected companies relationship for the whole of the period.

**Clause 59: Application of amortised cost basis to connected companies relationships**

110. This clause provides that where a loan relationship is a “connected companies relationship” (parties to a loan relationship are connected) both parties must use the same basis of accounting – the amortised cost basis rather than the fair value basis. This ensures both that the value of the loan cannot be artificially depressed and that debits in the one company are matched by credits in the other. The clause is based on section 87(1) and (2) of FA 1996.

111. In *subsection (2)* “for the period” has been added for clarification. The words do not appear in section 87(2) which this subsection rewrites.

**Clause 60: Companies beginning to be connected**

112. This clause provides the rule to be applied when companies begin to be connected under clause 59 and this involves a change in accounting basis from fair value accounting to the amortised cost basis. The clause is based on section 87(2A) and (2B) of FA 1996.

**Clause 61: Companies ceasing to be connected**

113. This clause provides the rule to be applied when companies cease to be connected under clause 59 and this involves a change in accounting basis from the amortised cost basis to fair value accounting. The clause is based on section 87(2A) and (2C) of FA 1996.

### **Clause 62: Disregard of related transactions**

114. This clause provides that credits and debits in respect of related transactions are only brought into account where they do not create greater deductions or smaller credits than would have been the case if the transactions had not taken place. The clause is based on paragraph 6(1), (2) and (6) to (8) of Schedule 9 to FA 1996.

## **Chapter 6: Connected companies relationships: impairment losses and releases of debts**

### ***Overview***

115. This Chapter provides rules for impairment losses and release of debt where there is a connection between the debtor and creditor companies.

116. Paragraph 5ZA of Schedule 9 to FA 1996 requires paragraphs 6, and 6C of that Schedule to apply in relation to a debit in respect of the release of a liability as they apply in relation to an impairment loss. In rewriting these paragraphs in this Chapter references to the release of a liability (referred to here as a “release debit”) have been inserted into the relevant clauses.

### **Clause 63: Introduction**

117. This clause explains the subject and layout of the Chapter and provides some definitions. The clause is based on section 87(3) of, and paragraphs 4A(8), 5ZA and 6C(1) of Schedule 9 to, FA 1996 and is new.

### **Clause 64: Exclusion of debits for impaired or released connected companies debts**

118. This clause provides the basic rule that neither impairment losses nor debits arising as a result of the release of a debt are brought into account if the debtor and creditor company are connected. The clause is based on paragraph 6(1) to (3) and (8) of Schedule 9 to FA 1996.

### **Clause 65: Cessation of connection**

119. This clause provides that debits for impairment losses or release debits which are not brought into account under the preceding clause are not to be brought into account in subsequent accounting periods after connection ceases. The clause is based on paragraph 6C(1) and (3) of Schedule 9 to FA 1996.

120. Paragraph 6C(3) of Schedule 9 refers to “(a) debit in respect of an amount” although there is now no preceding reference in the paragraph to an amount. This reference has been left over following an amendment by FA 2002. The sub-paragraph (1) previously read:

(1) Where, in the case of a creditor relationship of a company,-

(a) a departure that would otherwise have been allowed under paragraph 5(1) above in respect of an amount is or was, by virtue of paragraph 6 above, not allowed in the case of an accounting period; and

(b) there is a subsequent accounting period for which there is, within the meaning of section 87 of this Act, no connection between the company and any person standing in the position of a debtor as respects the debt,

sub-paragraphs (2) and (3) below shall apply.

121. The paragraph has been rewritten to reflect the fact that “the amount” refers to the impairment loss (or release debit by virtue of paragraph 5ZA of Schedule 9).

**Clause 66: Exception to section 64: swapping debt for equity**

122. This clause provides the first of two exceptions to the basic rule in clause 64. The exception in this clause applies when the liability is released in consideration for shares in the debtor company which give rise to the connection. The clause is based on paragraph 6(4) and (5) of Schedule 9 to FA 1996.

**Clause 67: Exception to section 64: insolvent creditors**

123. This clause provides the second exception to the basic rule in clause 64. The exception in this clause applies where the creditor is in insolvent liquidation, etc and the impairment loss or release debit accrues during the winding up, etc. The clause is based on paragraph 6A(1) and (2) of Schedule 9 to FA 1996.

**Clause 68: Exclusion of credits on release of connected company debts: general**

124. This clause precludes a debtor company from bringing into account under this Part the release of a debt where the debtor and creditor companies are connected. This clause excludes the credits on that release since clause 64 excludes the debits. The clause is based on paragraph 5(3) and (5) of Schedule 9 to FA 1996.

125. *Subsection (1)(b)* has been drafted to bring out the fact that the clause applies in respect of the accounting period in which the release occurs.

**Clause 69: Exclusion of credits on release of connected company debts during creditor’s insolvency**

126. This clause precludes a debtor company from bringing a credit into account on the release of a debt where the creditor company meets the insolvency etc conditions in clause 67 if the insolvency etc breaks the connected company relationship. The clause is based on paragraph 5(3) and (6) of Schedule 9 to FA 1996.

127. *Subsection (1)(d)* and *(e)* reflect the rule in section 12(7) and (7A) of ICTA that an accounting period ends with insolvency or administration.

**Clause 70: Exclusion of credits on reversal of impairments of connected companies debts**

128. This clause provides that the credit on a reversed impairment loss is not brought into account under this Part where that loss is not brought into account under clause 64. The clause is based on paragraph 6(3A) and (8) of Schedule 9 to FA 1996.

**Clause 71: Deemed release of liability: acquisition of creditor rights by connected company at undervalue**

129. This clause applies where a company acquires a debt from a third party as a result of which it becomes connected to the debtor. If the pre-acquisition value of the debt exceeds the consideration, the difference is treated as a release by the acquiring company and hence a charge on the debtor company. The clause is based on paragraph 4A of Schedule 9 to FA 1996.

130. Under paragraph 4A(2)(d) the provisions of that paragraph do not apply where the new creditor acquires the debt from a connected person. “Person” has been rewritten in subsection (1)(d) to apply to a company only. See *Change 2* in Annex 1.

**Q3. We welcome comments on the proposal to rewrite “person” as applying only to a company.**

**Clause 72: Deemed release of liability: parties becoming connected where creditor’s rights subject to impairment adjustment**

131. Where a debtor company and a creditor company become connected any reduction in the value of that debt as a result of an impairment loss which was not yet reflected in the book value of the debt at the time of acquisition is treated as a release by the creditor under this clause. The clause is based on paragraph 4A(4), (7) and (10) of Schedule 9 to FA1996.

**Clause 73: Companies connected for sections 71 and 72**

132. This clause explains what is meant by connected companies for the purposes of the two preceding clauses. The clause is based on paragraph 4A(8) and (9) of Schedule 9 to FA 1996.

133. This definition differs from the definition for connectedness in clause 142 by its application to periods of account rather than accounting periods.

**Chapter 7: Group relief claims involving impaired or released consortium debts**  
**Overview**

134. This Chapter provides rules to prevent both a claim to group relief surrendered by a consortium company and debits for impairment losses on loans made to the consortium company. The purpose of these rather complex provisions is to prevent a claim to “double relief”, ie in respect of both an impairment loss for the consortium member and a group relief claim surrendered by the consortium company, which would not arise in the case of companies within a group as a result of the rule in clause 64.

135. Paragraph 5ZA of Schedule 9 to FA 1996 requires paragraph 5A, on which this Chapter is based, to apply in relation to a debit in respect of the release of a liability as it applies in relation to an impairment loss. In rewriting these paragraphs in this Chapter references to the release of a liability (referred to here as a “release debit”) have been inserted into the relevant clauses.

**Clause 74: Introduction**

136. This clause sets out the general circumstances when the provisions of the Chapter will apply, what the Chapter does and, in *subsection (2)*, provides an important definition. The clause is based on paragraph 5ZA, 5A(1) to (4) and (16) and is new.

**Clause 75: Reduction of impairment loss debits exceeding group relief credits where group relief claimed**

137. This clause provides the basic rule: that group relief surrendered to a consortium member (or group company) by the consortium company is restricted by the surplus of impairment losses over credits arising on loans to the consortium company. The clause is based on paragraphs 5ZA and 5A(5) to (7) of Schedule 9 to FA 1996.

**Clause 76: Effect where credit for release brought into account on amortised cost basis**

138. This clause provides that where a consortium company brings in a credit on an amortised cost basis on the release of a liability by a consortium member and that member debits an equal amount, the debit is not taken into account under this Chapter. The clause is based in paragraphs 5ZA and 5A(15) of Schedule 9 to FA 1996.

**Clause 77: Reduction corresponding to reduction under section 75 where related credits exceed impairment losses**

139. This clause provides that where credits on loan relationships between the consortium member (or group company) and the consortium company exceed debits on those loans, the credits are reduced by debits previously reduced under the preceding clause. This compensates for the restrictions in an earlier period which would not have arisen had there not, in that period, been an excess of debits over credits. The clause is based on paragraph 5A(8) to (10) of Schedule 9 to FA 1996.

140. Paragraph 5A(8)(a) of Schedule 9 incorrectly refers to related debt recovery credits brought into account “under paragraph 5 above”. This is an incorrect reference and was overlooked in the consequential amendments to FA 2002 which removed paragraph 5(1) to (2A) of Schedule 9. This has been rewritten as if referring to the amounts brought into account in computing the “relevant net debits” (see paragraph 5A(5)(b)), which is the obvious meaning.

**Clause 78: Reduction of group relief where there are earlier net consortium debits**

141. This clause provides that claims for group relief surrendered by the consortium company to a consortium member (or group company) are reduced by the excess of debits over credits on loans to the consortium company in preceding years. The clause is based on paragraph 5A(11) to (13) of Schedule 9 to FA 1996.

**Clause 79: Carry forward of claims for group relief where there are no net consortium debts**

142. This clause applies where there is a claim for group relief by a consortium company (or group member) but no net debit in respect of debts with the consortium company. In those circumstances the group relief claim is carried forward and treated as increasing a group relief claim for the subsequent accounting period for the purposes of clause 75. The clause is based on paragraph 5A(14) of Schedule 9 to FA 1996.

**Clause 80: Group accounting periods**

143. This clause gives the meaning of “group accounting period” for the purposes of this Chapter. The clause is based on paragraph 5A(17) and (18) of Schedule 9 to FA 1996.

**Clause 81: Interpretation**

144. This clause defines various terms used in this Chapter. It is based on paragraph 5A(2) to (5) and (19) to (21).

**Chapter 8: Connected parties relationships: Late interest**

*Overview*

145. This Chapter gives the rules for bringing into account debits for interest which is paid late where the two parties to the loan are connected in some way.

**Clause 82: Introduction**

146. This clause explains the purpose of the Chapter and provides an overview. The clause is based on paragraph 2(1A) and (1D) of Schedule 9 to FA 1996 and is new.

**Clause 83: Late interest treated as not accruing until paid in some cases**

147. This clause sets out the basic rule that interest paid later than 12 months after the end of the accounting period is only allowed when paid if corresponding credits are not brought into account and one of the following clauses applies. The clause is based on paragraph 2(2) and (6) of Schedule 9 to FA 1996.

**Clause 84: Connection between debtor and person standing in position of creditor**

148. This clause gives the first circumstance when clause 83 applies. This is where the debtor and creditor companies are connected. The clause is based on paragraph 2(1A) and (1D) of Schedule 9 to FA 1996.

**Clause 85: Loans to close companies by participators etc**

149. This clause gives the second circumstance when clause 83 applies. This is where the company making the loan is a close company (other than a CIS-based close company or CIS limited partnership) and the creditor is a participator or similar. (CIS is an abbreviation of “collective investment scheme”.) The clause is based on paragraph 2(1B) and (1E) to (1G) of Schedule 9 to FA 1996.

**Clause 86: Interpretation of section 85**

150. This clause gives the meaning of various terms used in clause 85. The clause is based on paragraph 2(5) to (6) of Schedule 9 to FA 1996.

**Clause 87: Party to loan relationship having major interest in other party**

151. This clause gives the third condition when clause 83 applies. This is when either the debtor or creditor has a major interest (defined in clause 147) in the other. The clause is based on paragraph 2(1C) of Schedule 9 to FA 1996.

**Clause 88: Loans by trustees of occupational pension schemes**

152. This clause gives the fourth and final condition when clause 83 applies. This is when the loan is made by a trustee of an occupational pension scheme and there is a specified relationship between the debtor company and the employees benefiting from the scheme or their employing company. The clause is based on paragraph 2(1D) of Schedule 9 to FA 1996.

**Clause 89: Persons indirectly standing in the position of creditor**

153. This clause provides that preceding clauses on late interest which refer to the creditor company include companies which stand indirectly in that position as a result of a series of loan relationships or money debts. The clause is based on paragraph 2(3) and (4) of Schedule 9 to FA 1996.

**Chapter 9: Debts owed by or to partnerships involving companies**

*Overview*

154. This Chapter provides special rules for determining debits and credits on loan relationships where a money debt is owed by or to a partnership in which one or more of the members is a company.

**Clause 90: Debts owed by or to partnerships involving companies**

155. This clause gives the basic rule for computing the debits and credits where a money debt is owed by or to a partnership in which one or more of the members is a company. It is based on paragraph 19(1) and (2) of Schedule 9 to FA 1996 and is new.

156. “Profession” in paragraph 19(1)(a) has not been rewritten on the grounds that a company cannot carry on a profession for corporation tax purposes either as a partner or otherwise.

157. *Subsection (2)* adopts the language (“in accordance with the firm’s profit-sharing arrangements”) of clause 248 in the Partnerships Part in committee paper CC/SC(06)07 published in June 2006, which rewrites section 114(2) of ICTA 1988.

**Clause 91: Determination of debits and credits by company partners: general**

158. This clause expands on the basic rule given in subsection (3) of the previous clause. Each company partner is treated as owing or being owed the debt and the debits and credits in relation to those debts are treated as those of the company partner

in its profit-sharing ratio. The clause is based on paragraph 19(3) to (6) of Schedule 9 to FA 1996.

159. “Gross” in paragraph 19(5) and (6) of Schedule 9 means that the total credits and debits are calculated notwithstanding that the debt is treated as owed to or by each company partner and this is brought out in *subsection (5)*.

**Clause 92: Company partners using fair value accounting**

160. This clause provides that company partners using fair value accounting must bring debits and credits into account on the same basis. Without this provision it might be assumed that the deeming required by this Chapter did not require a company to adopt its normal accounting method. The clause is based on paragraph 19(11) of Schedule 9 to FA 1996.

**Clause 93: Inter-partnership lending between connected company partners etc**

161. This clause provides the rules for determining whether a company partner controls a partnership in circumstances where a money debt is between the partnership and a company partner. If it does so, then the rule in clause 59 applies under which debits and credits on a loan relationship are determined under the amortised cost basis. The clause is based on paragraph 19(7) to (9) of Schedule 9 to FA 1996.

**Clause 94: Treatment of exchange gains and losses**

162. This clause disapplies, in certain circumstances, the rule on exchange gains and losses in clause 23 which disallows a debit or credit on an exchange gain which is taken directly to a company’s reserves. Only where that exchange gain by-passes the partnership’s profit and loss account will that clause apply. The clause is based on paragraph 19(12) of Schedule 9 to FA 1996.

163. The words “subsection (3) of section 84A of this Act does not apply .... except to the extent that ..... exchange gains and losses are recognised” in paragraph 19(12) have been rewritten to clarify the meaning that the clause rewriting section 84A(3) applies *so far* as the exchange gains and losses` are recognised rather than the possible meaning that the clause applies only if they are recognised.

164. *Subsection (2)(a)* rewrites “statement of recognised gains and losses” as “statement of total recognised gains and losses” as being the usual accountancy term.

**Clause 95: Company partners’ shares where firm owns deeply discounted securities**

165. This clause treats deeply discounted securities held by a partnership as if they were held by each company partner in its profit-sharing ratio. The clause is based on paragraph 19(13) of Schedule 9 to FA 1996.

166. *Subsection (3)(b)* adopts the language (“in accordance with the firm’s profit-sharing arrangements”) of clause 248 in the Partnerships Part in committee paper CC/SC(06)07 published in June 2006, which rewrites section 114(2) of ICTA 1988.

## **Chapter 10: Special kinds of companies**

### ***Overview***

167. This Chapter provides rules for determining the gains and losses on the loan relationships of particular types of companies: investment trusts, venture capital trusts and certain non-resident companies holding War Loan.

### **Clause 96: Investment trusts: gains or losses of a capital nature**

168. This clause excludes gains and losses of a capital nature on loan relationships from being taken into account by an investment trust. Before FA 1996 these entities were treated as exempt from profits and gains which arose from the disposal of investments and that position was preserved in the loan relationships regime. The clause is based on paragraph 1A of Schedule 10 to FA 1996 and SI 2006/1182.

169. *Subsection (4)* rewrites paragraph 3 of The Investment Trusts and Venture Capital Trusts (Definition of Capital Profits, Gains or Losses) Order 2006 rather than referring to the appropriate SI as does paragraph 1A(3). It also updates the reference to the December 2005 revision for the Statement of Recommended Practice relating to Investment Trusts Companies.

170. Nonetheless *subsection (5)* retains the powers to amend the definition in subsection (3).

171. *Subsection (6)* allows orders to be made for “such incidental, supplemental, consequential and transitional provisions and savings”. This is a standard formulation for Bill 5 for the extra things that can be done under an order- and regulation-making power. It is not considered a change in the law.

### **Clause 97: Venture capital trusts: gains or losses of a capital nature**

172. This clause excludes gains and losses of a capital nature on loan relationships from being taken into account by a venture capital trust. Before FA 1996 these entities were treated as exempt from profits and gains which arose from the disposal of investments and that position was preserved in the loan relationships regime. The clause is based on paragraph 1B of Schedule 10 to FA 1996 and SI 2006/1182.

173. *Subsection (3)* rewrites paragraph 3 of The Investment Trusts and Venture Capital Trusts (Definition of Capital Profits, Gains or Losses) Order 2006 (SI 2006/1182) rather than referring to the appropriate SI as does paragraph 1B(3).

174. Nonetheless *subsection (5)* retains the powers to amend the definition in subsection (3).

175. *Subsection (6)* allows orders to be made for “such incidental, supplemental, consequential and transitional provisions and savings”. This is a standard formulation for Bill 5 for the extra things that can be done under an order- and regulation-making power. It is not considered a change in the law.

#### **Clause 98: Credit unions**

176. This clause provides that credits and debits on loan relationships of credit unions with union members are not brought into account under this Part. The effect is to treat the credit union, in those circumstances, as if it were a mutual society. The clause is based on section 487(1), (2) and (3A) of ICTA.

### **Chapter 11: Special rules for particular kinds of securities**

#### ***Overview***

177. This Chapter brings together a number of loan relationship rules from within and outside Chapter 2 of Part 4 of FA 1996 on particular types of securities.

178. Section 96 of FA 1996, which one might expect to be rewritten here, is not. The section prevents any rise in capital value of certain gilts from being brought into charge as credits on a loan relationship. The two gilts identified in the section are expressly protected from a capital gains charge and it was considered improper that a charge should arise on changes in capital value under the loan relationships legislation. Therefore the interest component only in any credit is taxed.

179. 3½% Funding Stock 1999-2004 was redeemed in June 2003. Since 5½% Treasury Stock 2008-2012 may be redeemed before this Bill is presented to Parliament the section is not, for the present, rewritten.

#### **Clause 99: Overview of Chapter**

180. This clause explains how the Chapter is organised. It is new.

#### **Clause 100: Index-linked gilt-edged securities: basic rules**

181. This and the following clause provide special rules for dealing with index-linked securities. This clause contains the main rules: that fair value accounting must be used and that adjustments under the following clause must be made. It also defines terms used in this and the following clause. The clause is based on section 94(1), (2) and (7) of FA 1996.

#### **Clause 101: Index-linked gilt-edged securities: adjustments for changes in index**

182. This clause applies to remove a gain or loss arising on an index-linked gilt-edged security by adjusting the value of the security in the accounts by the change in the retail prices index. It also provides for Treasury powers to amend the adjustments required under this clause. The clause is based on section 94(2) to (6) of FA 1996.

#### **Clause 102: Gilt strips**

183. This clause gives the rules that apply when a gilt-edged security is converted into strips and when strips are consolidated into a single security. In each case there is

a deemed redemption and acquisition. The clause is based on section 95(1) to (3) of FA 1996.

**Clause 103: Meaning of “strip”**

184. This clause gives the meaning of “strip” for this Chapter. It rewrites in full the definition from FA 1947 instead of relying on a cross-reference to that section as does section 95(7) of FA 1996. The clause is based on section 47 of FA 1942 and section 95(7) of FA 1996.

**Clause 104: Market value of securities**

185. This clause explains what is meant by the market value of a security in clause 102 and gives the Treasury power to amend that meaning. The clause is based on section 95(4) to (6) of FA 1996.

186. *Subsection (3)* allows orders to be made for “such incidental, supplemental, consequential and transitional provisions and savings”. This is a standard formulation for Bill 5 for the extra things that can be done under an order- and regulation-making power. It is not considered a change in the law.

**Clause 105: Restriction of deductions etc relating to FOTRA securities**

187. This clause prevents debits arising on FOTRA securities where gains from them are exempt. The clause is based on section 154(6) and (8) of FA 1996 and section 161(1), (4) and (7) of FA 1998.

**Clause 106: Non-UK resident bankers, insurers and security dealers with interest in 3½% War Loan 1952 Or After**

188. This clause restricts a debit for borrowing costs where a non-resident company holds 3½% War Loan for use in a trade of banking, insurance or dealing in securities. Interest on these securities is paid without deduction of tax and is exempt in the hands of a non-resident company. Because a company may borrow to acquire these securities avoidance might arise as a result of a mismatch between the absence of a credit in respect of an asset acquired by borrowings which give rise to an allowable debit. Consequently a proportion of the costs of borrowing is disallowed as a loan relationships debit. The clause is based on section 475 of ICTA 1988.

189. Although section 475(1) refers to a banking etc business *subsection (1)* rewrites this as a “trade”. “Business” is wider than “trade” but it is considered that banking, insurance and dealing in securities all constitute trades.

190. Step 2 in *subsection (3)* makes reference only to “interest which is not brought into account ... under this Part” (although section 475(2) and (4) of ICTA might be read as comprising other interest for corporation tax purposes) since interest can only be brought into account under loan relationships rules as a result of section 337A(2)(a) of ICTA.

191. *Subsections (1), (3) and (4)* rewrite “3½% War Loan 1952 or after” as “3½% War Loan 1952 Or After” to prevent the reader attaching the words “or after” to any following words, thus adopting the solution used in section 158(8)(b) of ICTA.

**Clause 107: Deeply discounted securities: introduction**

192. This clause introduces the following six clauses which all deal with deeply discounted securities. It explains how these clauses are arranged and provides two important definitions. The clause is based on paragraphs 17(3) and (4) and 18(2B) and (3) of Schedule 9 to FA 1996.

**Clause 108: Postponement until redemption of debits for connected companies’ deeply discounted securities**

193. This clause provides that debits on a deeply discounted security are, in certain circumstances, only brought into account under this Part on redemption where the debtor and creditor are connected. The clause is based on paragraph 17(1) to (3) and (5) of Schedule 9 to FA 1996.

**Clause 109: Companies with connections for section 108**

194. This clause explains what is meant by two companies being connected for the previous clause. The clause is based on paragraph 17(5) and (9) of Schedule 9 to FA 1996.

**Clause 110: Postponement until redemption of debits for close companies’ deeply discounted securities**

195. This clause provides that debits on a deeply discounted security can only be brought into account under this Part on redemption if the creditor is a participator etc in the debtor company. The clause is based on paragraph 18(1) to (2B) of Schedule 9 to FA 1996.

**Clause 111: Exceptions to section 110**

196. This clause provides exceptions to the preceding clause, where either credits equalling debits are brought into account under this Part or where the debtor company is a CIS-based close company or a CIS limited partnership. The clause is based on paragraph 18(1ZA) to (1C) and (4) of Schedule 9 to FA 1996.

197. In *subsection (4)* “the debtor company” in paragraph 18(1C)(c) of Schedule 9 has been rewritten for consistency as “the issuing company”, the term used elsewhere in that paragraph.

**Clause 112: Interpretation of section 110**

198. This clause provides definitions and deals with other matters necessary to interpret clause 110. The clause is based on paragraph 18(3B) to (5) of Schedule 9 to FA 1996.

**Clause 113: Persons indirectly standing in the position of creditor**

199. This clause enables clauses 108 and 110 to apply where there is a series of loan relationships between the company issuing the deeply discounted security and the person in the creditor relationship. The clause is based on paragraph 17(8) and (8A) and 18(2C) and (2D) of Schedule 9 to FA 1996.

200. Paragraph 18(2D) of Schedule 9 refers to the term “corresponding creditor relationship” in sub-paragraph (1A)(c). That sub-paragraph was repealed by FA 2002. This has been rewritten as if it referred to sub-paragraph (1A)(b), the sub-paragraph containing the reference to the person standing in the position of a creditor.

**Clause 114: Issue of funding bonds**

201. This clause treats issues of funding bonds as interest payments. It is based on section 582(1) to (2) and (3) to (4) of ICTA.

202. *Subsection (2)* rewrites, for clarification, “value of the bond at their time of issue” in section 582(1)(a) as “market value of the bonds at their issue”.

203. For the Schedule D Case VI charge in section 582(2) of ICTA see *Change 3* in Annex 1.

<p><b>Q4. Change 3 reproduces Change 82 in ITTOIA and so brings income tax and corporation tax back into line. We welcome comments on the proposal to carry change 82 in ITTOIA across to corporation tax.</b></p>
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**Clause 115: Redemption of funding bonds**

204. This clause prevents repayments of funding bonds from being a payment of interest if the issue was treated as such in the hands of an individual or company. The clause is based on section 582(1) and (4) of ICTA.

**Clause 116: Loan relationships with embedded derivatives**

205. Where GAAP requires separate treatment of a loan relationship and its embedded derivative this clause enables the loan relationship to be treated separately for the purposes of this Part also. The clause is based on section 94A(1) and (2) of FA 1996.

206. The Derivative contracts Part of Bill 5 will rewrite those parts of section 94A of FA 1996 that deals with the treatment of embedded derivatives under Schedule 26 to FA 2002.

**Clause 117: Election for application of section 116**

207. This clause permits a company subject to old UK GAAP to make an election to apply the treatment allowed under clause 116 although separate treatment of loan relationship and derivative does not apply under that accounting policy. The clause is based on paragraph 7(1), (4), (6) and (7) of Schedule 9 to FA 1996.

**Clause 118: Further provisions about elections under section 117**

208. This paragraph makes further provisions about elections under clause 117. The clause is based on paragraph 7(2), (3) and (5) of Schedule 9 to FA 1996.

**Clause 119: Assumption where options etc apply**

209. This clause deals with loan relationships accounted for under an amortised cost basis which are affected by options after the end of the accounting period. The debits and credits to be brought into account under this Part are those which would arise if the option were exercised in the way most favourable to the party to the loan relationship. The clause is based on paragraph 3(1) and (2) of Schedule 9 to FA 1996.

**Chapter 12: Anti-avoidance provisions**

*Overview*

This Chapter brings together provisions which counter avoidance, including avoidance which arises because transactions are not at arm's length.

**Clause 120: Overview of Chapter**

210. This clause explains what the Chapter is about and the provisions it contains. It is new.

**Clause 121: Loan relationships for unallowable purposes**

211. This clause prevents a company from bringing into account debits in respect of a loan relationship with an "unallowable purpose" (defined in the following clause) or exchange gains on such a loan relationship. Once such debits or credits are disallowed they are not brought into account for any other tax purposes. The clause is based on paragraph 13(1) and (2) of Schedule 9 to FA 1996.

**Clause 122: Meaning of "unallowable purpose"**

212. This clause gives the meaning of "unallowable purpose" for clause 121. It is based on paragraph 13(3) to (5) of Schedule 9 to FA 1996.

**Clause 123: Schemes and arrangements for obtaining relief for interest**

213. This clause prevents a company from bringing into account debits for interest paid as part of a scheme or arrangements, the sole or main benefit of which is the obtaining of the debit for that interest. The clause is based on section 787 of ICTA.

214. Section 787 differs from paragraph 13 of Schedule 9 to FA 1996, rewritten in clauses 121 and 122, in the following ways:

- paragraph 13 covers all debits and not just interest;
- paragraph 13 looks at the purposes of a loan relationship and section 787 at the benefit that might be expected to accrue from a scheme or arrangements;
- where section 787 is in point the whole of the interest is disallowed whereas paragraph 13 restricts only so much of the debit on the loan relationship as on a just and reasonable apportionment is attributable to the unallowable purpose.

215. For these reasons both paragraph 13 of Schedule 9 to FA 1996 and section 787 of ICTA are retained.

216. Section 787(1A) requires the reference in section 787(1) to giving relief in respect of a payment of interest to be read “as including” a debit for interest under Chapter 2 of Part 4 of FA 1996 (loan relationships). This must be interpreted as applying that subsection to loan relationships alone as debits for interest are only allowed under Chapter 2 of Part 4 of FA 1996 (section 337A(2)(a) of FA 1996). *Subsection (1)* is worded accordingly.

**Clause 124: Transactions not at arm’s length: general**

217. This and the following seven clauses provide rules for where transactions in respect of a loan relationship are not on arm’s length terms. This clause requires debits and credits brought into account in respect of loan relationships to be brought into account as if the transaction in respect of which they arise were on arm’s length terms. Exchange gains and losses are not affected. Schedule 28AA to ICTA (provision not at arm’s length) has priority over this rule (see clause 125). The clause is based on section 103(1) of, and paragraph 11(1) to, Schedule 9 to FA 1996.

**Clause 125: Disapplication of section 124 where Schedule 28AA to ICTA applies**

218. This clause provides an exception to clause 124. Where the debits and credits in question are either subject to an adjustment under the transfer pricing provisions in Schedule 28AA to ICTA or fall within that Schedule but do not require an adjustment, the arm’s length provisions in clause 124 do not apply. The clause also excludes an adjustment to exchange gains and losses from any Schedule 28AA adjustments. The clause is based on paragraphs 11(1A) and (1B) and 12(2ZA) of Schedule 9 to FA 1996 and paragraph 8(1) of Schedule 28AA to ICTA.

**Clause 126: Bringing into account adjustments made under Schedule 28AA to ICTA**

219. This clause requires credits and debits under this Part to reflect adjustments made under Schedule 28AA of ICTA. The clause is based on paragraph 16(1) and (2) of Schedule 9 to FA 1996.

**Clause 127: Exchange gains and losses: loans disregarded under Schedule 28AA to ICTA**

220. This and the following four clauses provide rules for exchange gains and losses on loan relationships which are not on arm’s length terms, such adjustments being excluded under both clauses 124 and 125. These clauses are all based on paragraph 11A of Schedule 9 to FA 1996. Paragraph 11A of Schedule 9 to FA 1996 is to be repealed by F(No.2)A 2005 with effect from a date to be appointed.

221. Under this clause where Schedule 28AA to ICTA, the transfer pricing provisions, provide that, in the case of a company with a debtor relationship, the whole or part of a loan is ignored, the exchange gains and losses on that loan, or a

proportion of them, are left out of account in computing gains under this Part. The clause is based on paragraph 11A(1) and (2) of Schedule 9 to FA 1996.

**Clause 128: Exchange gains and losses: equity notes held where holder associated with issuer**

222. This clause applies where interest is to be treated as a distribution under section 209(2)(e)(vii) of ICTA. Exchange gains and losses on the security giving rise to that interest are left out of account in computing gains under this Part in respect of the debtor company. The clause is based on paragraph 11A(1) of Schedule 9 to FA 1996.

**Clause 129: Exchange gains and losses: cases where no corresponding debtor relationship exists**

223. This clause applies where a company is in a creditor relationship and the transaction giving rise to the loan would not have been made on arm's length terms. Exchange gains and losses are left out of account where there is no corresponding debtor relationship (explained in clause 130). The clause is based on paragraph 11A(4) and (5) of Schedule 9 to FA 1996.

**Clause 130: Meaning of "relevant corresponding debtor relationship"**

224. This clause provides the meaning of "relevant corresponding debtor relationship" for the purposes of clause 129. The clause is based on paragraph 11A(4) of Schedule 9 to FA 1996.

**Clause 131: Exception to section 129 where loan exceeds arm's length amount**

225. Clause 129 applies where the transaction giving rise to the loan would not have been entered into at all on arm's length terms. That clause disallows the whole of the loan. This clause disapplies clause 129 where the loan would, on arm's length terms, have been of an amount more than nil but less than the full amount. In those circumstances a suitable proportion of the exchange gains and losses are taken into account for the purposes of this Part. The clause is based on paragraph 11A(5) and (6) of Schedule 9 to FA 1996.

**Clause 132: Connected parties deriving benefit from creditor relationships**

226. This clause provides that if a company receives less than a commercial return under a loan relationship and, in consequence, a connected company derives benefit as a result of that relationship, credits representing that benefit are brought into account in computing the creditor company's gains. This counters an avoidance device whereby a company arranges for the equivalent value of interest that would otherwise be received to be passed by the borrower to a connected company which is not a party to the relationship. The clause is based on section 93C of FA 1996.

**Clause 133: Application of fair value accounting: reset bonds etc**

227. This clause provides rules for debits and credits on loan relationships represented by bonds for which the terms of issue differ after issue, to be determined on the basis of fair value accounting. The clause is based on section 88A of ICTA.

228. Principally this clause counters avoidance where companies subscribe for reset bonds which increase in value after issue and are transferred to another group company at cost under clause 48 *et seq.* That company is then sold outside the group at market value with the gain on the bond reflected in the capital gain on the sale of the subsidiary and not as a credit under loan relationships.

### **Chapter 13: Non-trading losses**

#### **Overview**

229. This Chapter provides the rules for losses (currently “deficits”) on loan relationships which are not used for the company’s trade.

#### **Clause 134: Introduction**

230. This clause provides a general introduction to the Chapter. It is based on section 83(1) of, and paragraph 5 of Schedule 8 to, FA 1996 and is new.

#### **Clause 135: Basic rule for losses: carry forward to accounting periods after loss period**

231. This clause provides that losses which are neither surrendered as group relief nor set-off against profits of the loss period or earlier periods are carried forward against the non-trading profits of the following accounting period. The clause is based on section 83(3A) of, and paragraph 4(2), (3) and (6) of Schedule 8 to, FA 1996.

#### **Clause 136: Carry forward of loss to later accounting periods**

232. This clause allows a company to claim to carry forward the loss from the period in which it arose without the need to set it off against non-trading profits under clause 135. The loss is then treated as if it arose in the first later period and falls to be carried forward to the subsequent period (ie it cannot be set against profits of any description of that first later accounting period). This rule also applies where no claim is made but the loss cannot be set off against non-trading profits of the first subsequent period. The clause is based on paragraph 4(3) to (5) of FA 1996.

#### **Clause 137: Claims to set off loss against profits of loss period or earlier periods**

233. This clause allows a company other than a charity to claim that losses which have not been surrendered as group relief may be set off against other profits of the loss period or carried back against gains from loan relationships in an earlier accounting period. The clause is based on section 83(2) and (5) of FA 1996 and is new.

234. While section 83(2)(a) allows the loss to be set off against “any profits....(of whatever description)” section 83(2)(b) refers only to the set off “against profits”. Paragraph 3(4) of Schedule 8 to FA 1996 makes it clear that the profits in section 83(2)(b) are only those chargeable to tax under Case III from loan relationships. This restriction has been brought out in *subsection (1)(b)*. Full details of the profits against which a loss can be set under subsection (1)(b) are given in clause 141.

235. Section 83(5) has been rewritten in *subsection (3)* to exclude charities from making a claim under subsection (1) of this clause. References in section 83(5) to group relief are unnecessary since section 403(2) of ICTA now allows non-trading deficits for the purposes of group relief and these are defined in section 403ZC of ICTA as deficits to which section 83 of FA 1996 applies. Originally section 83(2)(b) enabled claims to be made for deficits to be surrendered as group relief but section 83(5) was not amended when section 83(2)(b) was repealed. Now, all that is necessary to prevent a deficit from being surrendered as group relief is to provide that clause 138 does not apply to it. So *subsection (3)* of the clause only needs to do that.

**Clause 138: Time limits and procedure for claims under section 137(1)**

236. This clause provides the time limit for a claim under clause 137 to be made. The clause is based on section 83(6) of FA 1996.

237. *Subsection (1)(b)* rewrites “the Board” as “an officer of Revenue and Customs”. See *Change 4* in Annex 4.

**Q5. We welcome comments on whether “the Board” should be rewritten as an officer of Revenue and Customs.**

**Clause 139: Claim to set off loss against other profits for the loss period**

238. This clause provides that, following a claim under clause 137(1), the loss is set off against the profits identified in the claim but after trade losses and before certain other reliefs. The clause is based on paragraph 1(1) to (3) of Schedule 8 to FA 1996.

**Clause 140: Claim to carry back loss to earlier accounting periods**

239. This clause explains how a claim to carry back a loss to an earlier period under clause 137(1)(b) applies. The loss is set against gains of later accounting periods before earlier ones. The clause is based on paragraph 3(1) to (3) of Schedule 8 to FA 1996.

240. *Subsection (2)* does not rewrite paragraph 3(2)(a)(ii), which refers to section 83(4) of FA 1996, as section 83(4) has been repealed.

**Clause 141: Gains available for relief under section 140**

241. This clause sets out which gains may be reduced by a loss carried back against gains of an earlier period under clause 137. The clause is based on paragraph 3(4) to (7) of Schedule 8 to FA 1996.

242. The reliefs in *subsection (5)* are set against the gains before the apportionment required by *subsection (3)* to give the “amount available for relief”.

243. The reference in subsection (5)(e)(i) to “section j2000” is to clause 3 in the Companies with Investment Business Part in committee paper CC/SC(07)07 published in February 2007.

## **Chapter 14: General and supplementary provisions**

### **Overview**

244. This Chapter explains when companies are connected for the purposes of the two Parts as well as providing definitions of “control”, “major interest” and other expressions.

### **Clause 142: Companies connected for an accounting period.**

245. This clause explains when two companies are connected for an accounting period for the purposes of any provisions that apply it. It is based on section 87(3) and (4) of FA 1996.

246. The reference in *subsection (1)* to “section j999994D” is to clause 81 of the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

### **Clause 143: Connections where partnerships are involved**

247. This clause explains when loan relationships are taken to be between connected companies in the case of debts owed by or to a partnership. The clause is based on section 87(5A) and (5B) of FA 1996.

248. *Subsection (4)* adopts the language (“in accordance with the firm’s profit-sharing arrangements”) of clause 248 in the Partnerships Part in committee paper CC/SC(06)07 published in June 2006, which rewrites section 114(2) of ICTA 1988.

### **Clause 144: Connection between companies to be ignored in some circumstances**

249. This clause provides that a connection between a company in a creditor relationship and the company in the debtor relationship are ignored in certain circumstances. These circumstances are set out in clause 145. The clause also provides that a company is treated for these purposes as being in a debtor relationship when the debt is dog-legged through intermediaries. The clause is based on section 88(1), (5) and (6) of FA 1996.

250. Section 88(1) and (5) refer to persons standing in a debtor relationship. Persons here has been rewritten as applying to companies only. See *Change 2* in Annex 1.

**Q6. We welcome comments on the proposal to rewrite “person” as applying only to a company.**

### **Clause 145: Conditions resulting in connections being ignored for section 144**

251. This clause sets out the circumstances under which connectedness between a company in a creditor relationship and one in a debtor relationship is ignored under clause 144. The clause allows financial traders who buy and sell debt of connected companies in the same way that they buy and sell debt of non-connected companies exemption from the connectedness rules. The clause is based on section 88(2) and (4) of FA 1996.

252. Section 88(3) of FA 1996 is applicable to life insurance companies and will probably not be rewritten in this Bill.

253. Section 88(2)(f) of FA 1996 provides the condition that, for a three month period, the equivalent of 30% or more of the assets should not be in the beneficial ownership of connected persons (explained in section 88(4)). Persons here has been rewritten as applying to companies only. See *Change 2* in Annex 1.

**Q7. We welcome comments on the proposal to rewrite “person” as applying only to a company.**

254. “Recognised stock exchange” in *subsections (3) and (6)* is defined in ICTA and is being signposted in the index to the Bill.

**Clause 146: Meaning of “control”**

255. This clause explains the meaning of control for the purposes of any provisions that apply it, for example clause 142 (see conditions A and B in that clause). The clause is based on section 87A(1) to (3) of FA 1996.

256. The reference in *subsection (1)* to “section j999994D” is to clause 81 of the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

257. The reference in *subsection (5)* to “section j190302” is to clause 248 of the Partnerships Part in committee paper CC/SC(06)07 published in June 2006.

258. *Subsection (6)(b)* adopts the language (“in accordance with the firm’s profit-sharing arrangements”) of clause 248 in the Partnerships Part in committee paper CC/SC(06)07 published in June 2006, which rewrites section 114(2) of ICTA 1988.

**Clause 147: Meaning of “major interest”**

259. This clause gives the meaning of “major interest”. The clause is based on paragraph 20(1), (3) and (8) to (10).

**Clause 148: Treatment of connected companies and partnerships for section 147**

260. This clause explains how the rule in clause 147(2) (meaning of “major interest”) on rights and powers is applied to partnerships with company members. The clause is based on paragraph 20(4) to (7) of Schedule 9 to FA 1996.

261. The reference in *subsections (2) and (8)* to “section j190302” is to clause 248 of the Partnerships Part in committee paper CC/SC(06)07 published in June 2006.

**Clause 149: Meaning of expressions relating to exchange gains and losses**

262. This clause explains what is meant by exchange gains and losses and gives the Treasury powers to make regulations as to how gains and losses related to such are to

be calculated where fair value accounting is used. The clause is based on section 103(1A) to (1B) of FA 1996.

**Clause 150: Meaning of “commercial rate of interest”**

263. This clause gives the meaning of “commercial rate of interest”. The clause is based on section 103(3A) of FA 1996.

**Clause 151: Other definitions**

264. This clause gives a number of definitions used in this Part. It is based on sections 103(1) of FA 1996.

265. In *subsection (1)* the definition of “share” excludes shares in a building society. In consequence it is considered that shares in building societies are not prevented from being loan relationships by section 81(4) of FA 1996. Section 477A(3)(a) and (aa) of ICTA, which requires dividends to fall within the loan relationship provisions, has consequently not been rewritten in Part 7.

266. Section 477B of ICTA, which allows a deduction for the incidental costs of issuing shares in a building society, is also considered unnecessary as such costs are allowed by section 84(3) of FA 1996 (rewritten in clause 21). The section has not therefore been rewritten.

267. The reference in *subsection (1)* to “section j190302” is to clause 248 of the Partnerships Part in committee paper CC/SC(06)07 published in June 2006.

**Part 7: Relationships treated as loan relationships etc**

***Overview***

268. The overview for this Part is included in the overview for Part 6.

**Chapter 1**

**Clause 152: Overview of Part**

269. This clause is new.

**Chapter 2: Relevant non-lending relationships: introduction**

***Overview***

270. This Chapter brings within the loan relationship provisions money debts which do not fall within the definition of a loan relationship in clause 9 because they do not arise from a transaction for the lending of money. The Chapter is based on section 100 of FA 1996.

**Clause 153: Relevant non-lending relationships: introduction**

271. This clause sets out the purpose of the Chapter and provides definitions. The clause is new.

**Clause 154: Relevant non-lending relationships not involving discounts**

272. This clause deals with the first type of debt which is not a loan relationship because it does not arise from a transaction for the lending of money. These are debts which do not involve discounts and on which interest, exchange movements or impairment losses arise. The clause is based on section 100(1) of FA 1996.

273. *Subsection (6)(c)* will refer to the appropriate clause in Chapter 7 of this Part when Schedule 13 to Finance Bill 2007 is rewritten.

**Clause 155: Relevant non-lending relationships involving discounts**

274. This clause deals with the second type of debt which is not a loan relationship because it does not arise from a transaction for the lending of money. These are debts which involve discounts, in particular the discount that arises where a sum due in respect of the sale of an asset is payable at a later date with the discount representing compensation for the late payment. The clause is based on section 100(1A), (1B) and (3A) of FA 1996.

275. *Subsection (7)(c)* will refer to the appropriate clause in Chapter 7 of this Part when Schedule 13 to Finance Bill 2007 is rewritten.

**Clause 156: Application of Part 6 to relevant non-lending relationships**

276. This clause explains how the provisions of Part 6 are to be applied to the preceding clauses on non-lending relationships. The clause is based on section 100(2) to (2ZB) and (3A) of FA 1996.

**Clause 157: Miscellaneous rules about amounts to be brought into account because of this Chapter**

277. This clause provides miscellaneous rules regarding non-lending relationships. The clause is based on section 100(3A), (3B) and (7) of FA 1996.

**Clause 158: Exchange gains and losses: amounts treated as money debts**

278. This clause brings exchange gains and losses on currency holdings and liabilities into the loan relationships legislation by treating them as money debts owed to the company. The clause is based on section 100(10) to (12) of FA 1996.

**Clause 159: Provision not at arm's length: meaning of "interest" and "money debt"**

279. This clause requires references to interest on money debts within this Chapter to include amounts treated as such under Schedule 28AA of ICTA (transfer pricing). The clause is based on section 100(3) of FA 1996.

**Clause 160: Exclusion of debts where gains or losses within Part [8] or Part [9]**

280. This clause excludes amounts from being brought into account under this Chapter if they are brought into account under the regimes for derivative contracts or intangible fixed assets. The clause is based on section 100(14) of FA 1996.

**Clause 161: Exclusion of exchange gains and losses in respect of tax debts etc**

281. This clause precludes exchange gains and losses from being taken into account under this Chapter where they arise on certain tax payments and sums which are not deductible against trading profits or as management expenses. The clause is based on section 100(9) of FA 1996.

282. The reference in *subsection (1)(b)(ii)* to “section j2000” is to clause 3 in the Companies with Investment Business Part in committee paper CC/SC(07)07 published in February 2007.

283. The reference in *subsection (2)* to “section j030701” is to clause 22 in the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

**Chapter 3: Unit trusts and offshore funds**

***Overview***

284. This Chapter provides the rules for calculating debits and credits under this Part where a company holds an interest in a unit trust or offshore fund and the assets held by those entities are at least 60% “qualifying investments”. These are broadly assets that are or represent loan relationships. The holdings are then treated as rights under a creditor relationship.

285. Holdings by companies in open-ended investment companies (and relevant definitions) are temporarily excluded from this Chapter. They are however included to the extent that they represent a qualifying investment and so are relevant to the qualifying investments test. They will be included in full following an expected statutory instrument to make amendments to paragraph 8 of Schedule 10 to FA 1996.

**Clause 162: Introduction**

286. This clause explains what the Chapter does, when it applies and gives a definition of “offshore fund”. The clause is based on paragraph 5(1) and (2) and 8(7F) of Schedule 10 to FA 1996.

287. The definition of “offshore fund” in paragraph 8(7F) of Schedule 10 has been applied throughout the Chapter. See *Change 5* in Annex 1.

<p><b>Q8. We welcome comments on the proposal to apply the definition of an offshore fund in section 756A of ICTA for all purposes of the qualifying investments test.</b></p>
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**Clause 163: Holdings in unit trusts and offshore funds treated as creditor relationship rights**

288. This clause provides the basic rule: if at any time in an accounting period a unit trust or offshore fund fails the qualifying investments test, a company’s holdings in such entities are treated as rights under a creditor relationship and the debits and credits are to be brought into account on the basis of fair value. The clause is based on paragraphs 4 and 7(1) of Schedule 4 to FA 1996.

289. *Subsection (1)(a)(ii)* provides that an interest in an offshore fund is only included if it is a material interest for the purposes of section 759 of ICTA. See *Change 5* in Annex 1.

**Q9. We welcome comments on the proposal to apply the definition of an offshore fund in section 756A of ICTA for all purposes of the qualifying investments test.**

**Clause 164: Holding coming within section 163: opening valuations**

290. This clause provides the opening valuation for holdings of a unit trust or offshore fund when first acquired. The clause is based on paragraphs 5(1) and 6 of Schedule 10 to FA 1996.

291. The words “the value of the asset” in paragraph 6 of Schedule 10 have been rewritten as “the value of the holding” since the words in paragraph 6 of Schedule 10 refer directly back to “valuation of the holding” in head (b) of that paragraph.

292. *Subsection (1)(c)* refers “the fair value accounting basis” instead of the “market value of the holding” in paragraph 6(1). This rectifies a missed amendment from FA 2004 which changed references from the latter wording.

**Clause 165: The qualifying investments test**

293. This clause explains what is meant by the qualifying investment test and how “qualifying investment” is to be interpreted when applied to each of the two entities. The clause is based on paragraph 8(1), (5) and (7F) of Schedule 10 to FA 1996.

**Clause 166: Meaning of “qualifying investments”**

294. This clause lists the investments which constitute “qualifying investments” and provides for Treasury powers to add to or subtract from the list. It is based on paragraph 8(2), (7) and (7E) of Schedule 10 to FA 1996 and paragraph 9 to Schedule 2 to FA 2005.

295. Paragraph 9 of Schedule 2 to FA 2005 requires paragraph 8(a)(i) “money placed at interest” to include a reference to arrangements falling within sections 47, 49 or 49A of FA 2005 (rewritten in Chapter 5 of this Part). The Unit Trust Schemes and Offshore Funds (Non-qualifying Investments Test) Order, SI 2006/981 also added a new paragraph 8(2)(h) “alternative finance arrangements” to the list of qualifying investments. This is defined in paragraph 8(7I) as arrangements within sections 47, 47A, 49 or 49A of FA 2005. Diminishing shared ownership in section 47A of FA 2005, rewritten in clause 175 is therefore included as a qualifying investment.

**Clause 167: Qualifying holdings**

296. This clause explains what is meant by “qualifying holdings” in a unit trust, OEIC or offshore fund within the qualifying investments list in the preceding clause. The clause is based on paragraph 8(3), (4) and (6) of Schedule 10 to FA 1996.

297. Paragraph 8(3)(b) has been rewritten to make it clear that “the same accounting period” refers to the accounting period of the company holding the investment in the unit trust etc and not the accounting period of the unit trust etc.

298. Paragraph 10(6A) and (6B) have not been rewritten because it is superfluous in the light of regulation 76 of the Authorised Investment Funds (Tax) Regulations 2006 SI 2006/964.

299. *Subsections (4) and (5)* refer to paragraphs 4 and 8 respectively of Schedule 10 to FA 1996 for the application of the qualifying investment test to open-ended investment companies. See the comments under the overview to this Chapter.

#### **Clause 168: Meaning of “hedging relationship”**

300. This clause provides the meaning of “hedging relationship” for this Chapter. It is based on paragraphs 8(7G) and (7H) of Schedule 10 to FA 1996.

#### **Clause 169: Power to change investments that are qualifying investments**

301. This clause gives the Treasury powers to amend this Chapter. The clause is based on paragraph 8(8) and 9 of Schedule 10 to FA 1996.

302. *Subsection (2)* allows orders to be made for “such incidental, supplemental, consequential and transitional provisions and savings”. This is a standard formulation for Bill 5 for the extra things that can be done under an order- and regulation-making power. It is not considered a change in the law.

### **Chapter 4: Industrial and provident societies**

#### ***Overview***

303. This clause brings payments in respect of shares in industrial and provident societies and agricultural co-operatives into the loan relationship regime. It does not treat the shares themselves as a loan relationship other than to allow dividends, etc on shares held for the purposes of a trade to be treated as trading income.

#### **Clause 170: Industrial and provident society payments treated as interest under loan relationships**

304. This clause treats certain payments of an industrial and provident society and agricultural and fishing co-operatives as payments of interest on a loan relationship. The clause is based on section 486(1), (9) and (12) of ICTA.

305. *Subsection (2)* treats dividends, bonuses and other sums payable on shareholdings held for the purposes of a trade or for other purposes as if that shareholding were a loan relationship so held. See *Change 1* in Annex 1.

**Q10. We welcome comments on whether dividends, etc on shareholdings held in an industrial and provident society should be treated as trading income as if the shareholding were a loan relationship held for the purposes of the trade.**

### **Clause 171: Disallowance of debits for interest where failure to make return**

306. This clause disallows a debit for interest paid by industrial and provident societies where returns under section 887 of ITA 2007 are not made within the specified period. Section 887 requires such companies to make returns of interest paid without deduction of tax. The clause is based on section 486(1), (7) and (12) of ICTA.

## **Chapter 5: Alternative finance arrangements**

### **Overview**

307. This Chapter treats arrangements that comply with Shari'a law as falling within the loan relationships regime. Under Shari'a law it is forbidden to give or receive interest and arrangements for the borrowing or lending of money will usually involve some form of risk sharing instead. The topic is commonly known as "Islamic finance" although the arrangements are used by non-Muslims. In this Chapter these arrangements are known as "alternative finance arrangements".

308. The Chapter sets out the nature of the four types of alternative finance arrangements in clauses 174 to 178 and then, in clauses, 179 to 182, explains which elements of the arrangements are treated as if they were loan relationships and which as interest payable under those relationships.

### **Clause 172: Introduction**

309. This clause provides an introduction to the Chapter by explaining what it does and provides definitions for the Chapter. The clause is based on section 46(1) of FA 2005 and is new.

### **Clause 173: Meaning of "financial institution"**

310. This clause gives the meaning of "financial institution". It is based on section 46(2) and (3) of FA 2005.

### **Clause 174: Purchase and resale arrangements**

311. This clause deals with the first type of financial arrangement, whereby an asset is purchased by a financial institution and then sold to another person with the payment by that second person left on credit. The price paid by that second person exceeds the price paid by the financial institution. The difference between the two prices equates to the return from an investment at interest and is treated as an alternative financial return (see clause 180). The clause is based on section 47(1) to (3) of FA 2005.

### **Clause 175: Diminishing shared ownership arrangements**

312. This clause deals with a second type of financial arrangement known under Islamic law as "diminishing musharaka". Two persons, at least one of them a financial institution, acquire an interest in an asset. The financial institution receives payments from the other party for that party's use of the financial institution's share as well as (usually leasing) payments, with the ownership of the financial institution passing by degrees to the second person. The second person in the arrangement has full use of the asset being acquired and may grant rights in the asset. Payments made by the second

person in excess of the payments for the beneficial interest being acquired are treated as an alternative financial return. The clause is based on section 47A(1) to (4) of FA 2005.

**Clause 176: Deposit arrangements**

313. This clause deals with a third type of alternative financial arrangement whereby deposits are made with a financial institution and payments are made to the depositor out of profits earned by the use of the money. The payments must equate to a return from an investment at interest. The return is treated as an alternative financial return. The clause is based on section 49(1) of FA 2005.

**Clause 177: Profit share agency arrangements**

314. This clause deals with the fourth and final type of financial arrangement, known as “wakala” in Islamic law. Here the investor appoints an agent to whom a sum of money is given to be invested at a specified return. Any additional sum above that specified return is retained by the agent as an incentive fee. The specified return is treated as an alternative financial return. The clause is based on section 49A(1) of FA 2005.

**Clause 178: Provision not at arm’s length: exclusion of arrangements from sections 174 to 177**

315. This clause excludes arrangements from clauses 174 to 177 where the parties are connected persons within the transfer pricing legislation in Schedule 28AA of ICTA, the arrangements are not at arm’s length and the recipient of the alternative financial return is not subject to income or corporation tax or a similar non-United Kingdom tax. The clause is based on section 52 (1) to (3) of FA 2005.

316. In *subsection (2)(c)(ii)* “an amount representing relevant return” covers back to back arrangements where there is an intermediary between the two parties to the arrangements.

**Clause 179: Treatment of alternative finance arrangements as loan relationships etc**

317. This clause explains which aspects of the four alternative financial arrangements in clauses 174 to 177 are to be treated as loan relationships for the purposes of this Part and what is to be treated as interest under that deemed loan relationship. “Alternative finance return” and “profit share return” for each of the four arrangements are defined in the following clauses. The clause is based on section 50(1) to (3) and (4A) of FA 2005.

**Clause 180: Meaning of “alternative finance return”: purchase and resale arrangements**

318. This clause explains the meaning of “alternative finance return” in relation to the purchase and resale arrangements in clause 174. This provides for where the second purchase price is paid either immediately or in instalments. The clause is based on section 47(6) and (8) of FA 2005.

**Clause 181: Meaning of “alternative finance return”: diminishing shared ownership arrangements**

319. This clause explains the meaning of “alternative finance return” in relation to the diminishing shared ownership arrangements in clause 175. The clause is based on section 47A(5) of FA 2005.

320. “Costs and expenses” in section 47A(5) has been reduced to “expenses” only in *subsection (3)* to avoid tautology.

**Clause 182: Meaning of “profit share return”**

321. This clause explains the meaning of “profit share return” in relation to deposit arrangements in clause 176 and profit share agency arrangements in clause 177. The clause is based on sections 49(2) and 49A(2) of FA 2005.

**Clause 183: Treatment of purchase and resale and diminishing shared ownership arrangements for other tax purposes**

322. This clause excludes the profits dealt with as interest under a loan relationship in relation to the arrangements under sections 174 or 175 from determining the sale or purchase price for other tax purposes (eg trading or capital gains). It does not prevent other tax provisions applying which substitute a different sum for a sale or purchase amount. The clause is based on section 53(1) to (3) of FA 2005.

**Clause 184: Treatment of principal under profit sharing agency agreements**

323. This clause prevents the person appointing the financial institution from being treated as entitled, as principal, to the agent’s profit share returns under the arrangements in section 177. The clause is based on sections 49A(3) of FA 2005.

**Clause 185: Provision not at arm’s length: non-deductibility of relevant return**

324. This clause prevents any deduction in calculating profits for corporation tax purposes as a result of the arrangements in clauses 174 to 177 or their income tax equivalents where the arm’s length rule in clause 178 applies. The clause is based on section 52(4) and (5) of FA 2005 and is new.

**Clause 186: Power to extend this Chapter to other arrangements**

325. This clause provides the Treasury with powers to introduce further arrangements into this Chapter and make consequential amendments to the Tax Acts as necessary. It is based on section 98 of FA 2006.

**Chapter 6: Shares with guaranteed returns etc**

***Overview***

326. The rules in this Chapter counter avoidance through the use of shares which function in a similar way to loan relationships but which fall outside the definition. The schemes making use of these shares exploit the fact that increases in value and gains from the disposal of shares are subject only to the rules for corporation tax on chargeable gains, if at all. The schemes use derivatives in conjunction with shares, or deferred subscription agreements to create what is in form a share but in economic

substance a deposit or loan, since in most of them the risks associated with equity investments, as well as the rewards, are removed or significantly reduced, leaving the share giving a return, either by the payment of “dividends” or by a wholly predictable increase in value, which is the type of return expected from debt.

**Clause 187: Introduction**

327. This clause sets out what the Chapter does, how it is arranged and some useful cross-references. The clause is based on sections 91A(1) and (1), 91B(1) and (7) of FA 1996 and is new.

328. Section 116B of TCGA (*subsection (6)*) will rewrite section 91G of FA 1996.

**Clause 188: Application of Part 6 to certain shares as rights under creditor relationship**

329. This clause treats rights in shares as loan relationships and distributions from such shares as debits or credits under this Part where either clause 189 or 191 applies. The clause is based on sections 91A(1) and (2) and 91B(1) and (2) of FA 1996.

**Clause 189: Shares subject to outstanding third party obligations**

330. This clause deals with the first type of shares to fall within clause 188: shares which increase in value in a similar way to an investment return as a result of an obligation by a third party (eg to pay a call). The clause is based on section 91A(1) and (5) to (6) of FA 1996.

**Clause 190: Meaning of “interest-like investment”**

331. This clause explains a term used in the previous clause. It is based on section 91A(7) and (8) of FA 1996.

**Clause 191: Non-qualifying shares**

332. This clause deals with the second type of shares to fall within clause 188: shares (“non-qualifying shares”) which produce predictable gains because of the nature of the assets underlying them. One of three conditions, dealt with in clauses 192 and 194 to 197, must be met for shares to fall within this category. The clause is based on section 91B(1) and (6) of FA 1996.

333. The reference in *subsection (1)(b)* to paragraph 4 of Schedule 10 to FA 1996 will be rewritten at a later date following expected amendments by statutory instrument to clarify the application of that Schedule.

334. The reference in *subsection (1)(c)* to “section j030116” is to clause 110 of the clauses in the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

**Clause 192: The increasing value condition**

335. This clause gives the first of the conditions necessary for a share to be a non-qualifying share within clause 191. This is where the assets of the company in which

the shares are held increase at a rate similar to commercial interest but which are not income-producing. The clause is based on section 91C(1) to (3) and (6) of FA 1996.

**Clause 193: Regulations about income-producing assets.**

336. This clause gives powers to the Treasury to add to the list of income-producing assets in clause 192. The clause is based on section 91C(4) and (5) of FA 1996.

**Clause 194: The redemption return condition**

337. This clause gives the second of the conditions necessary for a share to be a non-qualifying share within clause 191. This is where a redeemable share (with certain exceptions) produces a return similar to commercial interest. The clause is based on section 91D(1) to (2A) of FA 1996.

**Clause 195: The redemption return condition: excepted shares**

338. This clause explains which redeemable shares are excepted from meeting the condition dealt with by clause 194. The clause is based on section 91D(3) to (8) and (11) of FA 1996.

339. “Independent person” in section 91D has been rewritten in this clause as “persons not connected with the company” which is the definition in section 91D(11). Given that the definition in section 839 of ICTA applies, “persons” here refers to both companies and individuals. Section 839 is not separately referred to in this Part as that definition will apply for the whole of this Bill for “connected persons” and will be referred to in the General Provisions Part of the Bill. The use of “independent person” appears twice in Chapter 4 of Part 2 of FA 1996 with two quite different definitions. The other definition is in section 103 of FA 1996. The use of both terms has been replaced by their definitions.

**Clause 196: The redemption return condition: unallowable purposes**

340. This clause explains what is meant by an unallowable purpose to ascertain whether a share is a qualifying publicly issued share for the purposes of clause 195 and thus an excepted share for the redemption return condition. The clause is based on section 91D(9) to (11) of FA 1996.

341. The reference in *subsection (1)(a)* to “section j030116” is to clause 110 in the Trading Income Part in committee paper CC/SC(06)07 published in June 2006.

**Clause 197: The associated transactions condition**

342. This clause gives the third and final condition necessary for a share to be a non-qualifying share within clause 191. This is where neither of the other conditions is met but there is a scheme or arrangements under which the combined effect of the shares and another transaction produce a return similar to a commercial rate of interest. The clause is based on section 91E(1) to (3).

**Clause 198: Power to change conditions for non-qualifying shares**

343. This clause gives the Treasury the power to vary the conditions to be met under which shares may be “non-qualifying shares” for the purposes of clause 191. The clause is based on section 91F of FA 1996.

**Clause 199: Amounts to be brought into account where section 188 applies**

344. This clause gives rules concerning the amounts to be brought into account for the purposes of this Part by the company holding the shares. The clause is based on sections 91A(3), (4) and (9) and section 91B(3) and (4) of FA 1996.

**Clause 200: Shares ceasing to be shares to which section 188 applies**

345. This clause treats shares which cease to fall within section 188 as having been disposed of and reacquired. The clause is based on section 91G(2) of FA 1996.

**Chapter 7: Manufactured interest etc**

*Overview*

346. This Chapter treats “manufactured interest” (payments representing interest under stock-lending or a repo agreement) as interest under a loan relationship. The clauses reflect the two consequential amendments to section 97 in paragraph 16 of Schedule 14 to Finance Bill 2007.

**Clause 201: Introduction**

347. This clause explains when a company has a “manufactured interest relationship”. The clause is based on section 97(1) and (4) of FA 1996.

**Clause 202: Manufactured interest treated as interest under loan relationship**

348. This clause provides the main rule that the manufactured interest is treated as if it were interest under a loan relationship and the manufactured interest relationship is treated as if it were a loan relationship. It also ensures that debits and credits in respect of related transactions can still be taken into account after the company no longer has the right to receive manufactured interest (to prevent the sale of rights to receive such interest to third parties). The clause is based on section 97(2), (2A) and (4B) of FA 1996.

**Clause 203: Disallowance of debits for deemed payments representative of interest under stock lending arrangements**

349. This clause disallows a debit under the loan relationship provisions for representative payments under section 736B(2) of ICTA. The clause is based on section 97(4A) of FA 1996.

**Part 16: Exempt income**

**Chapter 1: Income from loan relationships**

*Overview*

350. This Chapter exempts from corporation tax gains arising from certain loan relationships.

**Clause 204: Interest from tax reserve certificates**

351. This clause exempts interest on tax reserve certificates from corporation tax. The clause is based on section 46(2) of ICTA.

**Clause 205: Introduction: securities free of tax to residents abroad (“FOTRA securities”)**

352. This clause sets out the three different classes of United Kingdom Government securities exempt in the hands of non-residents (FOTRAs) and defines the term “the exemption condition” and “gilt-edged security” used in this and the following clause. The clause is based on section 154(8) of ICTA and section 161 of FA 1998.

353. 7.25% Treasury Stock 2007 (*subsection (5)*) was issued with the main condition that “the Stock will be exempt from all United Kingdom taxation, present or future, so long as it is shown that the Stock is in the beneficial ownership of persons who are ordinarily resident in the United Kingdom”. The condition does not apply where a trade is carried on in the United Kingdom or for purposes of tax avoidance by United Kingdom residents.

**Clause 206: Exemption of profits from FOTRA securities**

354. This clause exempts FOTRA securities specified in clause 205(2) from corporation tax and sets out the two conditions that must be met if that exemption is to apply. The clause is based on section 154 of FA 1996.

**Clause 207: Income from savings certificates**

355. This section provides an exemption for income from savings certificates where the holding is within specified limits. The clause is based on section 46(1), (3), (4) and (7). of ICTA.

356. The source legislation refers to the limits in terms of purchase by, or on behalf of, a person. *Subsection (2)* rewrites this as “acquisition” to avoid confusion for situations such as joint ownership where special regulations apply. It also refers to the regulations as limiting a person’s holding in line with the way the regulations are written.

357. *Subsection (2)* introduces the words “so far as”. This allows exemption to be conferred in part in respect of multiple savings certificates. See *Change 6* in Annex 1.

<p><b>Q11. Change 6 reproduces Change 112 in ITTOIA and so brings income tax and corporation tax back into line. We welcome comments on the proposal to carry Change 112 in ITTOIA across to corporation tax.</b></p>
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**Clause 208: Income from Ulster Savings Certificates**

358. This section provides an exemption for income from Ulster Savings Certificates for holdings within specified limits. The section is based on section 46 of ICTA, which also deals with savings certificates generally (see clause 207).

359. Although Ulster Savings Certificates have not been issued since March 1997, there are still holdings which have not been redeemed. Consequently it is necessary to rewrite this provision to ensure that interest continuing to be paid in respect of these holdings is exempt from corporation tax.

360. *Subsections (4)* introduces the words “so far as”. This allows exemption to be conferred in part in respect of multiple savings certificates. See *Change 6* in Annex 1.

361. *Subsection (4)* uses “acquisition” rather than purchase and refers to a person’s holding in line with the way the regulations are written.

362. *Subsection (5)* does not specify that the claim for exemption is to be made to the Board. Where a notice to deliver a corporation tax return has been issued, paragraphs 57 and 58 of Schedule 18 to FA 1998 require the claim to be made in the return or by amendment of the return if possible. See *Change 4* in Annex 1.

**Q12. Change 4 reproduces Change 149 in ITTOIA (as modified to reflect section 50 of the Commissioners for Revenue and Customs Act 2005) and so brings the income and corporation tax codes back into line. We welcome comments on the proposal to carry Change 149 in ITTOIA (as so modified) across to corporation tax.**

## ANNEX 1

### **Change 1: Interest and dividends from industrial and provident societies treated as income from a trade where shareholding held for purposes of trade: clause 170(2)**

This change provides that share interest and loan interest of a registered industrial and provident society and share interest of an agricultural co-operative society are treated as trading income where the company is a party to the respective shares or loan for the purposes of a trade.

Income from loan relationships is charged under Schedule D Case I if the relationships is used for the purposes of a trade (see section 80(2) of FA 1996) and otherwise under Schedule D Case III (see section 80(3) of that Act).

Section 486(1) of ICTA provides that, notwithstanding anything in the Tax Acts, share or loan interest payable by a registered industrial and provident society is to be treated as interest under a loan relationship of the society. Section 486(4) requires any share or loan interest paid by such a society to be chargeable under Schedule D Case III.

“Share interest” is defined in section 486(12) to include dividends or other sums payable to a shareholder by reference to his shareholding in the society. “Loan interest”, which is also defined in section 486(12), would fall within the loan relationships provisions (Chapter 2 of Part 4 of FA 1996) regardless of section 486. However section 486(4) arguably has the effect of charging such interest under Case III only, but the matter is unclear as the wording “notwithstanding anything in the Tax Acts” applies to section 486(1) only and the point arises as to whether section 486(4) is overridden by section 80 of FA 1996 which would give Chapter 2 of Part 4 of FA 1996 precedence.

Section 81(4) of FA 1996 excludes share capital from being treated as a debt and hence from being a loan relationship. It seems that the wording of section 486(1) does not require the shareholding itself to be treated as a loan relationship. For that to be the case the definition of “share” in section 103 of FA 1996 would need amendment in the same way that it is amended to exclude building society shares which, as a result, are treated as loan relationships. Section 477A(3) of ICTA, which is not unlike section 486(1), merely requires building society dividends to be treated as liabilities arising under a loan relationship but does not extend the deeming provision to the shareholding.

Section 486(9) requires subsection (1) (but not subsection (4)) to have effect as if references to an industrial and provident society include a reference to an agricultural co-operative society which complicates the matter still further.

The resulting situation appears to be as follows.

### *IPSs other than agricultural cooperative societies*

All interest which, regardless of section 486 of ICTA, would fall to be brought into account under Chapter 2 of Part 4 of FA 1996 (“natural interest”), other than interest in respect of loan relationships of a co-operative society is chargeable under that Chapter but (arguably) solely as Schedule D Case III income.

All dividends etc which are only treated as income under a loan relationship by virtue of section 486(1) are chargeable under Chapter 2 of Part 4 of FA 1996 but solely as Schedule D Case III income. Regardless of whether section 486(4) applies to such income or not there is no underlying loan relationship to fall within section 80(2) of FA 1996 and the income is chargeable under Case III by virtue of section 80(3) FA 1996. Crown Option cannot apply in this case since the charge can only be to Schedule D Case III. (Crown Option is the right given by paragraph 84 of Schedule 18 to FA 1998 to an officer of Revenue and Customs to chose between different cases of Schedule D.)

### *Agricultural co-operative societies*

All natural interest paid by an agricultural co-operative society is chargeable under Chapter 2 of Part 4 of FA 1996 as payment under a loan relationship. The interest is chargeable under Schedule D Case III under section 80(3) unless the underlying loan relationship is held for the purposes of a trade, in which case the income is chargeable under Case I of that Schedule by virtue of sections 80(2) and 82(2). The interest does not fall within section 486(4) so there is no obligatory Case III charge under that section.

All dividends paid by an agricultural co-operative society are chargeable under Chapter 2 of Part 4 of FA 1996 as payments under a loan relationship. The dividends do not fall within section 486(4) so there is no obligatory Case III charge under that subsection. But, since there is no underlying loan relationship to fall within section 80(2) of FA 1996, the income is chargeable under Case III by virtue of section 80(3) FA 1996.

These clauses have effect both by ignoring the Schedule D Case III charge in section 486(4) of ICTA and by assuming the existence of an underlying loan relationship that may be held for the purposes of a trade.

***This change is in principle adverse to some taxpayers and favourable to others but is expected to be favourable in most cases.***

**Change 2: References to connections between a company and another person to be rewritten as applying to connections between two companies: clauses 58(2) to (5), 71(1), 144(1) and (3) and 145(5) and (7)**

This change rewrites references to a company connected with a person so as to refer to a connection between two companies.

Section 87 of FA 1996 provides for the amortised cost basis to be used when bringing into account debits and credits on loan relationships when there is a connection between the creditor company and *a person* standing in the position of the debtor or between a debtor company and *a person* standing in the position of a creditor.

Section 87(3) explains what is meant by a connection between a company and another person for the purposes of section 87. The definition is only in terms of the person being a second company. This was not always the case. Section 87(3)(c) originally included the case of a participator of the debtor or creditor company or an associate of the participator until that head was repealed by FA 2002. The definition of “participator” in section 417 of ICTA can include an individual.

The most likely interpretation is therefore that “person” in section 87(1) and (3) of FA 1996 means “company”. Section 87 has been rewritten accordingly. The far less likely interpretation is that section 87(3) only provides the definition where the other person is a company and that it is up to the courts to interpret what is meant by connection in section 87(1) where the person is an individual. Section 839 of ICTA, which provides a definition of “connected persons” including connected persons who are not companies, only applies where the section itself is applied (see section 839(1)). It is not applied in section 87 although it is elsewhere in the loan relationship provisions.

Section 88 of FA 1996 provides exceptions to the connection provision in section 87.

Section 88(1) provides that a connection between a creditor company and the person standing in the position of debtor in the exempt circumstances set out in section 88 is disregarded for the connection provisions of section 87. Although section 88(5) provides a refinement of that rule for the debtor company *if* the person standing in the position of a debtor is also a company, it is not clear how the person in subsection (1) who is the debtor could be other than a company, since section 87, as explained above, now only provides connection rules between companies. Section 88(1) and (5) has therefore been rewritten as applying to debtor companies only.

Section 88(2) excludes cases where, broadly, loan relationships are treated as trading assets. But heads (e) and (f) of that subsection do not allow the exclusion where the asset representing the loan relationship has, under certain conditions, been in the beneficial ownership of “connected persons”.

Section 88(4)(b) explains what is meant by a connected person having the beneficial ownership of assets by applying the meaning of a connection given by section 87 of FA 1996. “Connected person” here has therefore also been rewritten as referring to a connected company.

Paragraph 4A of Schedule 9 to FA 1996 provides for the deemed release of a loan (and hence a charge on the debtor company) where the creditor company acquires the loan from a second person for an amount less than the carrying value in the accounts of the debtor company. Under sub-paragraph (2)(d) this provision does not apply

where there is a connection between the new creditor company and the *person* from whom it acquired that debt. Sub-paragraph (8) provides the meaning for the purposes of the paragraph of connection between a company and another person. In both instances the other person is a company.

It seems probable therefore that “person” in paragraph 4A(2)(d) refers to a company only. Indeed the effect of this is that no charge arises from a released debt where a loan is passed between group companies.

The far less likely interpretation is that paragraph 4A(8) of Schedule 9 to FA 1996 only provides the definition where the other person is a company and that it is up to the courts to interpret what is meant by connection in paragraph 4A(2)(d) where the person is an individual. Paragraph 4A(2)(d) has therefore been rewritten as being only of relevance where the person is a company.

***This change is in principle adverse to some taxpayers and favourable to others. But it is expected to have no practical effect as it is in line with current practice.***

**Change 3: Funding bonds: charge to tax as interest: clause 114(2)**

This change replaces a theoretical but unlikely charge to tax under Schedule D Case VI with a charge under the loan relationships legislation where funding bonds are issued for which it was impractical to retain any bonds on account of income tax.

This change reproduces Change 82 in ITTOIA and so brings income tax and corporation tax back into line.

Section 582(1) of ICTA generally treats the issue of funding bonds as a payment of interest and they are taxed accordingly. But there is one situation where funding bonds are charged to tax under Schedule D Case VI, rather than as interest. Section 582(2)(b) of ICTA provides that where it is “impracticable” to retain bonds the recipient is instead chargeable to tax under Schedule D Case VI.

It would however be extremely unusual for a Case VI charge to arise on a company. Under section 349A(1) of ICTA a company or authority is not obliged to deduct tax where a company is resident in the United Kingdom or, if not resident, the payment is within the charge to corporation tax charged under section 11 of ICTA. The only likely instance of a Case VI charge arising on a company liable to corporation tax (and hence the loan relationships regime) under section 582 is where tax is deductible on interest because it is paid other than by a company or authority. The only obvious example is a payment of a United Kingdom public revenue dividend under section 349(3C) and public revenue dividends are unlikely to give rise to funding bonds.

Section 582(3A) provides that the provisions of section 582 override the provisions of Chapter 2 of Part 4 of FA 1996 and thus the rules in section 582 will apply where that treatment differs from treatment under the loan relationships regime.

As section 582(1) of ICTA treats funding bonds as a payment of interest for all purposes of the Taxes Acts, applying a different charge under Schedule D Case VI in just one situation has no particular logic, adds an unnecessary complication and, as explained above, is extremely unlikely to arise in the first place. So the separate charge has not been reproduced. Clause 114(2) ensures that all issues of funding bonds are charged to tax as interest, irrespective of the circumstances in which they are issued.

Case VI loss relief has not been preserved given the unlikelihood of a Case VI change. The exemption from tax for income charged under Case III which is applied for charitable purposes (section 505(1)(c)(ii) of ICTA) will however now apply.

*This change is in principle adverse to some taxpayers and favourable to others. But it is expected to have no practical effect as it is in line with current practice*

**Change 4: References to “officer of Revenue and Customs”: clauses 138(1) and 208(5)**

This change replaces references to the “Board of Inland Revenue” in the source legislation with references to “an officer of Revenue and Customs”.

References in the source legislation to the “Board of Inland Revenue” are treated by section 50(1) of the Commissioners for Revenue and Customs Act 2005 (CRCA) as references to “the Commissioners for Her Majesty’s Revenue and Customs”. The rest of this note accordingly refers to the Commissioners for Her Majesty’s Revenue and Customs (“the Commissioners”) rather than to the Board of Inland Revenue.

The provisions affected by this change will in future authorise or require things to be done by or in relation to an officer of Revenue and Customs rather than by or in relation to the Commissioners. This reflects the way in which Her Majesty’s Revenue and Customs is organised and operates in practice. Section 13 of CRCA allows nearly all functions conferred on the Commissioners to be exercised by any officer. All of the functions affected by this change, which are in the main concerned with administrative processes, are in fact exercised by officers of the Commissioners, and the Commissioners themselves are not personally involved in their exercise.

Where the source legislation provides for a claim or election to be made to the Commissioners, this Bill does not expressly state to whom such a claim or election is to be made. Where a notice to deliver a corporation tax return has been issued, paragraphs 57 and 58 of Schedule 18 to FA 1998 require the claim to be made in the return or by amendment of the return if possible. A return must be made to the officer who issued it. A notice amending a return must be made to an officer. Similarly, where the claim is made outside a return or amendment, paragraph 2(1) of Schedule 1A to TMA requires the claim to be made to an officer.

Each provision affected by the conversion of references to the Commissioners will be identified in the Table of Origins by a cross-reference to this change.

In clause 208 this change brings the income and corporation tax codes back into line.

*This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.*

**Change 5: Definition of offshore funds for qualifying investment test: clauses 162(4) and 163(1)(a)(ii)**

363. This change provides that the definition of “offshore fund” in paragraph 8(7F) of Schedule 10 to FA 1996 applies for all purposes of the “non-qualifying investment test” (known as the “qualifying investments test” in this Part).

364. Paragraph 4 of Schedule 10 to FA 1996 provides for a company’s “relevant interest in an offshore fund” to be treated as a right under a creditor relationship where the fund fails to satisfy the non-qualifying investments test: broadly where more than 60% of the holdings of the fund represent investments that would be loan relationships if held directly by the company.

365. The meaning of “relevant interest in an offshore fund” for the purposes of paragraph 4 is given by paragraph 7 of the same Schedule. This is a material interest in an offshore fund for the purposes of Chapter 5 of Part 17 of ICTA or an interest which would be such an interest on the assumption that the unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA were not limited to collective investment schemes. Section 756A of ICTA, which gives the meaning of “relevant interest in an offshore fund” for the purposes of Chapter 5 of Part 17, requires that offshore funds should be collective investment schemes.

366. The “non-qualifying investment test” referred to in paragraph 4(1) is found in paragraph 8 of Schedule 10. Paragraph 8(7F) requires “offshore fund”, for the purpose of the test, to have the same meaning as in Chapter 5 of Part 17 of ICTA. It does not carry the assumption in paragraph 7(1)(b) of Schedule 10 that unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA need not be limited to collective investment schemes.

367. The definition in paragraph 8(7F) clearly applies to offshore funds held by the investing company, ie the same company and the same offshore fund referred to in paragraph 4(1) (to which the definition in paragraph 7 refers) since the definition also construes “assets of an offshore fund”. This can only refer to “assets of the fund” in paragraph 8(5)(b), which paragraph in turn gives the meaning of “investments of an offshore fund” for the purposes of paragraph 8(1) (“investments of ... the fund”). This is the offshore fund referred to in paragraph 4(1).

368. In consequence the wider definition of relevant interest in paragraph 7 of Schedule 10 is lost when paragraph 8 of Schedule 10 is applied, because any such non-collective investment scheme is excluded from the test by the definition of “offshore fund” in paragraph 8(7F). The wording of paragraph 4(1) makes it clear that the “offshore fund” referred to in that paragraph should be subject to the test in

paragraph 8 of Schedule 10. But if a company has a material interest in an offshore fund under paragraph 4 as a result of the assumption in paragraph 7(1)(b), that fund is not recognised for the purposes of the non-qualifying investments test.

369. Therefore the narrower definition of an offshore fund is adopted in clause 162(4) and, as the assumption in paragraph 7(1)(b) of Schedule 10 serves no purpose, it is excluded from the reference to interests in offshore funds in clause 163(1)(a)(iii) for the purposes of the qualifying investments test.

*This change is in principle adverse to some taxpayers and favourable to others. But it is expected to have no practical effect as it is in line with current practice.*

**Change 6: Exempt income: savings certificates: unauthorised purchases involving multiple certificates: clauses 207(2) and 208(4)**

This change enables multiple savings certificates to be regarded as authorised in part where an unauthorised number of certificates has been purchased, and so confers exemption on the income from the part that is so regarded.

The Treasury limit the number of savings certificates of any particular issue that a person is permitted to purchase. The limits are stated in the prospectus for each issue.

The income from savings certificates is exempt from corporation tax under section 46 of ICTA. However, the exemption only applies to certificates purchased within the permitted limits. Section 46(3) of ICTA provides that the exemption does not apply to savings "... certificates ... purchased ... in excess of *the amount* which a person is for the time being authorised to purchase ...". It is not entirely clear how this would work in the case of multiple certificates. (These are certificates which represent a number of individual unit certificates.)

For example, if the maximum number of certificates permitted is 100, X holds 80, and then purchases a multiple certificate of 50, section 46(3) of ICTA appears to prevent the exemption from applying to the second multiple certificate. However, in practice, the second certificate is treated as 50 individual certificates, so that 20 would be treated as authorised and 30 as unauthorised.

Clauses 207(2) and 208(4) reflect this practice by providing that certificates are authorised "so far as" their acquisition was not prohibited by regulations made by the Treasury limiting a person's holding or, in the case of Ulster Savings Certificates, such regulations made by the Department of Finance and Personnel.

*This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.*