

## Summary: Intervention & Options

Department /Agency:  
HM Revenue and Customs

Title:  
Changes to rules on loan relationships

Stage: Consultation

Version: 1

Date: 28 July 2008

**Related Publications:** HM Revenue and Customs Consultation Document 'Changes to corporation tax rules on late payments of interest between connected companies'

Available to view or download at:

<http://www.hmrc.gov.uk/consultations/index.htm>

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**What is the problem under consideration? Why is government intervention necessary?**

Recent decisions of the European Court of Justice have raised the question of whether one of the current corporation tax rules on interest payments between connected companies is compatible with principles of European law which guarantee non-discrimination. It is necessary to amend paragraph 2 of Schedule 9 to Finance Act 1996 in order to ensure that the corporation tax rules are compliant with European law. Options on changing the rule are under consideration.

**What are the policy objectives and the intended effects?**

- To amend the current rule in such a way that it is compatible with European law.
- To prevent tax avoidance arising from payments of interest between connected companies.
- To ensure, as far as possible, minimal impact upon Exchequer receipts for the Government and tax liabilities and administrative burden for companies.

**What policy options have been considered? Please justify any preferred option.**

- To deny a tax deduction to a UK company for late interest paid to a connected creditor company where the creditor company is within UK tax rules, in the same way that currently applies to interest paid by a UK company to a connected creditor company that is not within the UK corporation tax rules.
- To repeal the current rule and replace it with an anti-avoidance measure.

Comments have been invited on these options and there is no clear preference at this stage.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?** A further impact assessment will be published taking account of responses to the consultation

**Ministerial Sign-off** For consultation stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

Kitty Usher

.....Date: 17 July 2008

## Summary: Analysis & Evidence

Policy Option: A

Description: Deny tax deduction to UK company for late interest paid to connected creditor company within UK tax rules

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' More companies will be required to make tax computational adjustments than is currently the case, and there will be a one-off cost of familiarisation with the amended legislation. Overall the option will not have a significant impact on administrative costs for companies.	
	<b>One-off</b> (Transition)	<b>Yrs</b>		
	<b>£ likely to be neg</b>			
	<b>Average Annual Cost</b> (excluding one-off)			
	<b>£ likely to be neg</b>		<b>Total Cost (PV)</b>	<b>£ likely to be neg</b>
Other <b>key non-monetised costs</b> by 'main affected groups' Other costs will be assessed in the light of responses to consultation.				

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' The option will remove uncertainty over the current legal position and make compliance with tax rules clearer where there are late payments of interest between connected companies.	
	<b>One-off</b>	<b>Yrs</b>		
	<b>£ to be quantified</b>			
	<b>Average Annual Benefit</b> (excluding one-off)			
	<b>£ to be quantified</b>		<b>Total Benefit (PV)</b>	<b>£ to be quantified</b>
Other <b>key non-monetised benefits</b> by 'main affected groups' The option will not provide other non-monetised benefits.				

**Key Assumptions/Sensitivities/Risks** 1. That the compliance cost of the amended rule would be very similar to that of the current rule. 2. That this option is not expected to have a significant effect on companies' tax costs, subject to the findings of the consultation.

Price Base Year 0	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £ to be quantified
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What is the geographic coverage of the policy/option?			UK wide		
On what date will the policy be implemented?			From March 2009		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£ nil		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			No		
What is the value of the proposed offsetting measure per year?			£ n/a		
What is the value of changes in greenhouse gas emissions?			£ n/a		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro low	Small low	Medium low	Large low
Are any of these organisations exempt?		No	No	N/A	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			(Increase - Decrease)		
Increase of	£ nil	Decrease of	£ nil	<b>Net Impact</b>	£ nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

## Summary: Analysis & Evidence

<b>Policy Option: B</b>	<b>Description: Repeal current rule and replace it with anti-avoidance measure</b>
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<b>COSTS</b>	<b>ANNUAL COSTS</b>	Description and scale of <b>key monetised costs</b> by 'main affected groups' Fewer companies will be required to make computational adjustments, but all companies will need to consider the possible application of the anti-avoidance rule. There will be a one-off cost of familiarisation. Overall the option will not have a significant impact on administrative costs for companies.
	<b>One-off</b> (Transition) <span style="float: right;">Yrs</span>	
	£ likely to be neg	
	<b>Average Annual Cost</b> (excluding one-off)	
£ likely to be neg	<b>Total Cost (PV)</b>	£ likely to be neg
Other <b>key non-monetised costs</b> by 'main affected groups' Other costs will be assessed in the light of responses to consultation.		

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>	Description and scale of <b>key monetised benefits</b> by 'main affected groups' The option will remove uncertainty over the current legal position and make compliance with tax rules clearer where there are late payments of interest between connected companies.
	<b>One-off</b> <span style="float: right;">Yrs</span>	
	£ to be quantified	
	<b>Average Annual Benefit</b> (excluding one-off)	
£ to be quantified	<b>Total Benefit (PV)</b>	£ to be quantified
Other <b>key non-monetised benefits</b> by 'main affected groups' The option will not provide other non-monetised benefits.		

**Key Assumptions/Sensitivities/Risks** 1. That the compliance cost of the amended rule would be very similar to that of the current rule. 2. That this option is not expected to have a significant effect on companies' tax costs, subject to the findings of the consultation.

Price Base Year	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £ to be quantified
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What is the geographic coverage of the policy/option?	UK wide				
On what date will the policy be implemented?	March 2009				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£ nil				
Does enforcement comply with Hampton principles?	Yes				
Will implementation go beyond minimum EU requirements?	No				
What is the value of the proposed offsetting measure per year?	£ n/a				
What is the value of changes in greenhouse gas emissions?	£ n/a				
Will the proposal have a significant impact on competition?	Yes/No				
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Micro</td> <td style="width: 25%; text-align: center;">Small</td> <td style="width: 25%; text-align: center;">Medium</td> <td style="width: 25%; text-align: center;">Large</td> </tr> </table>	Micro	Small	Medium	Large
Micro	Small	Medium	Large		
Are any of these organisations exempt?	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	No	No	N/A	N/A
No	No	N/A	N/A		

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)		(Increase - Decrease)
Increase of £ nil	Decrease of £ nil	<b>Net Impact</b> £ nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

## Evidence Base (for summary sheets)

### Introduction

1. The corporation tax rules on loan relationships are set out in Chapter 2 Part 4 Finance Act (FA) 1996. These rules govern the tax treatment of interest and other profits and losses relating to corporate debt. They apply to all companies, regardless of whether they are small, medium or large enterprises. Any change to loan relationships rules may, therefore, affect all companies within the charge to corporation tax. The loan relationships rules apply only for the purposes of corporation tax and do not affect unincorporated businesses.
2. The basic principle of these rules is that for tax purposes a company's profit or loss from its loan relationships is that computed from the 'credits' and 'debits' which, in accordance with generally accepted accounting practice, are recognised in the company's accounts. Generally accepted accounting practice is for both the creditor and the debtor company to recognise accrued amounts, regardless of when those amounts are paid. In most cases, therefore, the loan relationships rules achieve symmetry between the taxation of interest payable and receivable between companies. A debtor company gets a tax deduction for interest or other payments recognised in its accounts in respect of a loan, and the creditor company is taxed on the corresponding amounts recognised in its accounts.
3. However, where debts are between connected parties, the tax treatment departs from the normal 'follow the accounts' principle found in the loan relationships rules. One such connected party provision denies a tax deduction in the debtor company for interest paid late.
4. This rule is set out in paragraph 2 of Schedule 9 FA 1996, which applies in a number of cases, where interest payable by a debtor company to a connected creditor is not paid within 12 months of the end of the accounting period in which it accrues, and is not brought into account by the creditor under the loan relationships rules. In such a case, the debtor company is allowed a deduction for the interest only when it is paid. The rule addresses the asymmetry which may arise where a debtor is allowed a tax deduction for interest accrued, but the creditor is taxable only on receipt.
5. One of the cases in which paragraph 2 operates is where the connected creditor is a company that is not within the UK's loan relationships rules. This affects a relatively small number of companies which are debtor companies within the loan relationships rules, and which have not paid interest accruing in the accounts, where the connected creditor company is not resident in the UK.
6. Recent decisions of the European Court of Justice have raised the question of whether the rule as it stands may constitute a restriction of European Community Treaty freedoms, because it in effect discriminates against borrowing from non-UK resident company. Whilst the correct legal position is arguable, the Government has decided to put the matter beyond doubt by amending the law.

### Options for change

7. Two main options have been considered for amending the operation of paragraph 2, consistent with preserving the policy objective of preventing the Exchequer loss which may arise from the asymmetrical taxation of loan relationship debits and credits, and consistent with the key principles of the loan relationships regime.

#### *Option A: apply paragraph 2 to all connected companies*

8. Under this option, paragraph 2 would be amended so that a debtor company would be denied a deduction for late interest payable to a connected creditor company within section 87A FA 1996, regardless of whether the latter brings in credits under the loan relationships rules.

9. The effect of this change would be that paragraph 2 would be extended to include all UK to UK loans between connected companies, and the rule would therefore operate in cases where it currently does not apply. The connected debtor company would be required to make computational adjustments where interest remained unpaid 12 months after the end of the accounting period in which it accrues. No computational adjustment by the creditor company would be needed.
10. It is recognised that an objection to this change is that it could result in double taxation in an intra-group situation; that is, denial of a tax deduction in the debtor company, while the creditor is taxed on the corresponding interest on accrual in the company accounts. However, in most such cases, it is believed that the effect of the rule would be avoided by simply paying the interest in question, either in cash or by funding bond.
11. In cases where the debtor company is genuinely unable to pay the interest, the normal operation of accounting standards may itself prevent double taxation in an intra-group situation. An adjustment to the connected creditor company's receipts in respect of the unpaid interest which is recognised in its accounts would be allowable for the purposes of the loan relationships rules, although not where this is an impairment loss.

*Option B: repeal paragraph 2(1A) and insert a new anti-avoidance rule*

12. Under this option, the relevant part of paragraph 2 (paragraph 2(1A)) would be repealed. There would instead be an anti-avoidance rule to address the issue of asymmetry between connected debtor and creditor companies where there is late-paid interest. Such a rule would deny a tax deduction to the debtor company for unpaid interest where the benefit, or one of the main benefits, of not paying the interest was the obtaining of a tax advantage.
13. In most cases, a debtor company would continue to be allowed a tax deduction for accrued interest in accordance with normal loan relationships rules. The anti-avoidance rule would aim to prevent manipulation of connected party debt where interest payable by the debtor remains untaxed in the creditor.

*Other options*

14. There are other possible approaches to this issue, but there are difficulties in following them.
15. For example, paragraph 2 might be amended to deny a UK debtor company a deduction for late interest payable to a connected foreign creditor company only where the foreign company is not taxable in its home state on a basis that is equivalent to the loan relationships rules. However, it would be difficult in practice to specify which foreign tax regimes could be regarded as equivalent to the loan relationships rules, and such an approach might not be sufficient to address fully the issue of the compatibility of the current rule with European law.
16. Alternatively, as a variation on Option A, a debtor company would be denied a deduction for late interest payable to a connected creditor company, but the interest receivable by the creditor company would be taxed when received. This would mitigate the effect of Option A in the sense that it would ensure symmetry between the loan relationship debit in the debtor company and the loan relationship credit in the connected creditor company. However, again, such an approach might not be compatible with European law, since it would apply only to a creditor within the loan relationships rules. Nor would it necessarily prevent asymmetry between UK and non-UK connected companies.
17. Furthermore, this approach would in effect impose a paid basis on all interest payments between connected companies, which would be inconsistent with the accrual of the interest in the company's accounts and run against the grain of the loan relationships regime, and give rise to complicated interactions with other loan relationships rules.
18. For these reasons, Option A and Option B are considered to be the only realistic options for amending paragraph 2. However, the Consultation Document invites comments on both options and other possible variations on them.

## **Impact on companies within the loan relationships rules**

19. The Consultation Document seeks comments on the impacts of the options, including the cost of compliance and the administrative burden on companies, to enable these to be quantified. The loan relationships rules apply to all companies within the scope of corporation tax in the UK (around 2 million), but only the minority of these are within groups or are otherwise likely to be affected by special rules on connected parties. The most significant compliance costs from this legislation will fall on fewer than 1000-2000 large groups, and it is estimated that fewer than 1000 companies would be affected by any change to the current rules. Even then, it is likely that these companies can avoid the impact of the changes with a minimal amount of forward planning, so the cost, although impossible to estimate at present, is likely to be negligible.
20. Both options would involve minor changes to the loan relationships rules, with which all companies are required to comply in preparing their corporation tax computations, and neither would represent a significant increase in the cost of compliance. In each case there would be a one-off cost of familiarisation with new legislation, but again this would not be significant in terms of the overall impact of annual changes to tax legislation.

### *Option A*

21. Option A would require more debtor companies to make computational adjustments for tax purposes than is currently the case, in cases where interest payable to a connected creditor is unpaid more than 12 months after the end of the accounting period. However, the majority of companies would be unaffected by the change since they would be able to avoid any computational adjustment by simply paying the interest in question. A very small number of companies would be unable to do so for a range of commercial reasons.

### *Option B*

22. Option B would require fewer companies to make computational adjustments than is the case under the current rule. Only those companies caught by the anti-avoidance provision would be required to make an adjustment. All companies are currently required to consider the possible application of existing anti-avoidance provisions within the loan relationships rules. It is anticipated that a new anti-avoidance provision would operate in a similar manner to those existing anti-avoidance rules.

## **Impact on small firms**

23. The loan relationships rules do not apply to unincorporated businesses and there will be no impact on such firms from any change to these rules.
24. Any change to the corporation tax rules on loan relationships will have a potential impact on all companies, although overall the impact is expected to be small; small companies are unlikely to be disproportionately affected. Small companies are less likely than medium or large companies to be part of a group of companies or otherwise be connected within the loan relationships rules, and as such any change to the rules is less likely to have an impact upon them.
25. Small companies are most likely to be affected by the rule in paragraph 2 that applies where interest is paid late to a close company participator. It is not proposed that there should be any change to paragraph 2 as it affects such cases, and no impact arises.

## **Competition Assessment**

26. There is unlikely to be any difference in impact on particular companies or sectors of the economy from changes to the tax rules on late payments of interest between connected companies, and no competition issues arise.

## **Legal Aid**

27. The proposals for amending paragraph 2 Schedule 9 FA 1996 affect only companies and will have no impact on Legal Aid.

## **Sustainable Development, Carbon Assessment, Other Environment, Health Impact Assessment**

28. The proposals for amending paragraph 2 Schedule 9 FA 1996 affect only the computation of corporation tax liabilities of companies and will have no impact, either positive or negative, on either the environment or public health.

## **Race Equality, Disability Equality, Gender Equality, Human Rights Equality**

29. The proposals for amending paragraph 2 Schedule 9 FA 1996 affect only the computation of corporation tax liabilities of companies and will have no impact on race, disability, gender or Human Rights equality.

## **Rural proofing**

30. The proposals for amending paragraph 2 Schedule 9 FA 1996 affect only the computation of corporation tax liabilities of companies and will neither impact on nor be impacted on by rural proofing.

## **Conclusion**

31. HMRC's view is that either option A or Option B described above would meet the policy objective of amending the current rule in paragraph 2 Schedule 9 FA 1996 in such a way that it is compatible with European law, while preventing tax avoidance within the loan relationships rules arising from payments of interest between connected companies and ensuring, as far as possible, minimal impact on Exchequer receipts and administrative burdens on companies. However, one of the key purposes of the Consultation is to identify whether this is a valid assumption.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No