Analysis

FB 2016: Asymmetric notional finance charges

Speed read

The transfer pricing rules already apply to non-commercial loans. The accountants have now got in on the act through section 11 of FRS 102. This requires interest free loans to be discounted, with concomitant notional finance charges to unwind the discount. Finance (No. 2) Act 2015 radically recast the loan relationship rules with effect from accounting periods beginning on or after 1 January 2016. Finance Bill 2016 has now further adapted the rules to eliminate asymmetries arising from notional finance charges.

David Southern QC
Temple Tax Chambers
David Southern QC is a barrister in Temple Tax Chambers. He undertakes all forms of tax litigation, specialising in business taxation, financing, debt restructuring and VAT. He is currently conducting numerous judicial review proceedings of accelerated payments notices. The tenth edition of his *Taxation of loan relationships and derivative contracts* will be published later this year. Email: david.southernqc@templetax.com; tel: 020 7353 7884.

Schedule 7 of the Finance Bill 2016 (FB 2016) makes limited changes to the loan relationships and derivative contracts rules. The aim of these changes is to remove asymmetries in tax accounting for deemed finance charges, i.e. cases where a notional finance charge is incurred, and a deductible loan relationship debit of 100 in the debtor company is not matched by a corresponding credit of 100 in a creditor company.

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These measures can only be understood in the context of earlier wide ranging accounting and legislative changes, in particular:

- 'Modernising the taxation of corporate debt and financial instruments' (6 June 2013). This was HMRC's plan for changes to the legislation.
- The imposition of FRS 102 for accounting periods beginning on or after 1 January 2015. This was part of the FRC's convergence programme to eliminate differences between IFRS and UK GAAP.
- F(No. 2)A 2015 Sch 7. This effected an extensive revision of the loan relationships and derivative contracts rules, with the changes to take effect for accounting periods beginning on or after 1 January 2016.

The Finance Bill 2016 changes take effect from 1 April 2016. Where an accounting period straddles 1 April 2016, the period is divided into two periods, according to FB 2016 Sch 7 para 12(2).

Symmetry

The loan relationship rules were introduced in FA 1996. The central structural principle of the new system was that of symmetry; in other words, every debit of 100 in the debtor should be matched by a credit of 100 in the creditor, and vice versa. To that end, the distinction between income and capital was abolished, and an all-income accruals approach adopted. This resulted in the costs of debt finance being wholly untaxed in the borrower and wholly taxed in the lender. The widespread use of SSAP 20 hedging extended the symmetry concept into derivative contracts.

Non-commercial loans

Non-commercial loans are loans made to a company on terms more favourable than market terms (as to interest, duration or amount). They are usually found in the form of a loan made by an individual shareholder or by a parent company shareholder to a company in which the provider of funds holds shares. They are common in SMEs (where the transfer pricing rules do not apply) and in group situations (where they may do).

Under old UK GAAP, such loans were recognised at cost. Modern standard setters take the view that it is misleading to describe such loans as having a nil or reduced financing cost. The finance cost has simply been wrapped up in the amount lent. Accordingly, non-commercial loans should be regarded as discounted debt. In consequence, FRS 102 requires a company to recognise interest-free and non-market rate loans at the present value of future payments, discounted at the putative market rate of interest for a similar debt. The loan then accretes back to the redemption amount over its term. The borrower company has an initial credit to equity and subsequent notional finance charges of the same amount, taking the loan from its discounted amount to the repayment amount.

This gives rise to notional finance costs, i.e. finance costs which do not involve any transfer of benefits to a third party, but which are deemed to do so.

It is important to note that if the loan is repayable on demand, it can be recognised at transaction value, and there is no requirement to discount the amount repayable on redemption under FRS 102. In that case, the loan should be included amongst short term creditors.

Example 1: notional finance charges

Mr Brown and his family own all the shares in Brown Engineering Ltd (an SME). The accounting reference date is 31 March. Mr Brown lends the company 1,000 interest free on 1 April 2014, repayable after four years. The company adopts FRS 102 on 1 April 2015. For accounting purposes, we have to assume that a bank has made a fixed rate loan at, say, 8% for four years.

Brown Engineering Ltd will be deemed to incur notional finance costs as follows:

Year	Opening amount	Finance cost	Closing amount
To 31 March 2016	794	63	857
To 31 March 2017	857	68	925
To 31 March 2018	925	75	1,000
Total		206	

On 1 April 2015, on its first adoption of FRS 102, Brown Engineering Ltd will make the following adjustments to its accounts:

- DR liabilities: 206
- CR equity: 206

The credit to equity will be unwound over the next three years, as shown above.

The question is: how will these accounting items be treated for tax purposes? Two sets of rules are of significance:

- In the case of non-commercial transactions ('provision not at arm's length'), the transfer pricing rules in TIOPA 2010 Part 4 require a company to make transfer pricing adjustments in respect of its loan relationships or derivative contracts, but only if the adjustment would produce an increased charge to UK tax. In that case, those adjusted debits and credits are used to calculate its profits on loan relationships and derivative contracts in priority to the loan relationships and derivative contracts rules, under CTA 2009 ss 445, 446 and 693. These rules apply both to UK to UK transactions and to UK to non-UK transactions.
- Where the transfer pricing rules are not in issue (for example, for SMEs), the loan relationships and derivative contracts rules apply. These are (up to a point) based on commercial accounts, not an arm's length standard.

Transitional rules

A number of situations need to be distinguished with regard to non-commercial loans:

i. loans in existence prior to the adoption of FRS 102 on or after 1 January 2015;
ii. category (i) loans in existence at the start of an accounting beginning on or after 1 January 2016; and
iii. new loans coming into existence after 1 April 2016.

Category (i) loans

Under CTA 2009 ss 315–317, if a change in accounting policy led to a change in the carrying value of a loan relationship, the change in value had to be brought into account for tax purposes (as for accounting purposes) in the first period in which the new accounting policy was adopted. On that basis, Brown Engineering Ltd (in example 1 above) would have a loan relationship credit of 206 in its accounting period beginning on 1 April 2015.

Under the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations, SI 2004/3271, regs 3, 3A, debits and credits prescribed by reg 4 ('the applicable amounts') shall be brought into account over the 'prescribed period', which is ten years. Prior period adjustments and adjustments on change of accounting policy come within reg 4. Hence the credit of 206 (in example 1 above) will be spread over ten years.

Category (ii) loans

The F(No. 2)A 2015 Sch 7 changes apply for accounting periods beginning on or after 1 January 2016 (para 103). For such accounting periods, amounts that are included in 'other comprehensive income' (OCI) are not taken into account in computing a company's loan relationships and derivative contracts profits, until they are recycled to profit and loss (CTA 2009 s 308(1)(1A), as amended by F(No. 2)A 2015 Sch 7 para 5).

In the case of Brown Engineering Ltd (in example 1 above), the credit of 206 went to OCI under the previous accounts; and was taken into account as a credit under the loan relationship rules. Under F(No. 2)A 2015 Sch 7 paras 115, 116, there are transitional provisions in relation to amounts that:

- were recognised in the company's accounts as other items of OCI;
- have not been recycled to profit and loss in an accounting period beginning before 1 January 2016;
- have been brought into account as credits or debits under the loan relationship rules in an accounting period beginning before 1 January 2016; and
- would be taxable under CTA 2009 s 308(1A) (or s 597(1A) in the case of derivative contracts) on being transferred to profit and loss.

Debits reversing the credit will be brought into account over a five-year period. Under para 116(5), this occurs on a sliding scale, as follows:

- year 1: 40%;
- year 2: 25%;
- year 3: 15%;
- year 4: 10%; and
- year 5: 10%.

Category (iii) loans

For new loans coming into existence after 1 April 2016, the credit on recognition to the borrower is no longer taxable (CTA 2009 s 308(1) (as amended)).

Brown Engineering Ltd would incur a double debit (finance cost and transitional adjustment). That would not offend the symmetry principle, provided that another party had a corresponding credit. However, as the lender is Mr Brown, he will only be taxed on interest or discounts received in cash. An individual is not liable to tax on deemed finance charges. There will be no matching UK tax liability.

Non-commercial loans should be regarded as discounted debt

To cater for this situation, with effect from 1 April 2016 the new CTA 2009 s 446A is introduced by FB 2016 Sch 7 para 2. This section applies where a loan liability is initially, or on change of accounting basis, recognised in the borrower's company's accounts at a discounted amount. To the extent that there is no corresponding credit, the 'relevant discount amount' is not to be included in the borrower's loan relationship debits for corporation tax purposes. The 'relevant discount amount' (deemed finance cost, ordinarily deductible as a loan relationship debit) will be eliminated by CTA 2009 s 446A in two situations:

a) where the creditor is an individual; and
b) where the creditor is a company resident in a non-qualifying territory, or a company effectively managed in a non-taxing non-qualifying territory.

The rationale for this is that the lender would not be chargeable to UK tax on the notional finance receipt, so that there would be a debit but no corresponding taxable income.

'Non-qualifying territory' (as in situation (b) above) means a territory other than one with which the UK has a double taxation agreement containing an appropriate non-discrimination provision (TIOPA 2010 s 173). 'Non-taxing' means having no corporate taxation.

Hence, for Brown Engineering Ltd the result would be:

Year	Finance cost	Credit (spread over ten years)	Debit set against credit	Notes	S 446A – 'relevant discount amount'
To 31 March 2016	(63)	20.60	(42.40)	Unwinding of credit	
To 31 March 2017	(68)	20.60	(65.44)	40% of unrelieved credit	68
To 31 March 2018	(75)	20.60	(40.90)	25%	75
To 31 March 2019		20.60	(24.54)	15%	
To 31 March 2020		20.60	(16.36)	10%	
To 31 March 2021		20.60	(16.36)	10%	
To 31 March 2022		20.60			
To 31 March 2023		20.60			
To 31 March 2024		20.60			
To 31 March 2025		20.60			
Total		206	(206)		

Transfer pricing

FB 2016 Sch 7 para 3 provides that there is to be no loan relationship credit unless it reverses a preceding debit under the transfer pricing rules. In other words, where a transfer pricing adjustment has been made in respect of a loan, a company is not required to bring in as a credit a discount on inception of the loan. The same rule applies to derivative contracts (FB 2016 Sch 7 para 4, amending CTA 2009 s 693).

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Example 2: transfer pricing rules

Consider the situation where Global plc, resident in the UK, has a wholly owned subsidiary Local Co, resident in state B. Global lends Local Co £10m interest free for ten years. Under the transfer pricing rules, interest of 7% a year is attributed to Global. Under FRS 102, the loan is accounted for as a loan asset of £6m and a capital contribution of £4m. There is no debit for this under the transfer pricing rules (because it would reduce Global's UK profits). When Global records a notional financial receipt unwinding the discount, that is not taken into account under the loan relationship rules.

Transfer pricing and foreign exchange matching

If a UK borrower has a foreign currency loan from a connected non-resident lender, and part of the loan is ignored for transfer pricing purposes (because a third party lender would only have lent a smaller sum), the foreign exchange gains and losses on any unrecognised part of the loan will also be disregarded for UK tax purposes (CTA 2009 s 447(1)–(4). A difficulty arises if the loan in question is matching an asset expressed in a foreign currency, i.e. the loan functions in a hedging relationship. This is because foreign exchange gains on the disregarded part of the loan will be left out of account, but not exchange differences on the matched asset. FB 2016 Sch 7 para 5 confines the disregard to the unmatched part of the loan, by introducing CTA 2009 s 447(4A). This is accompanied by a series of further amendments, relating to:

- debtor relationships that are 'equity notes' (CTA 2009 s 448; CTA 2010 s 1015(6));
- creditor relationships not at arm's length (CTA 2009 ss 449, 451); and
- derivative contracts (CTA 2009 s 694).

In turn, a definition of 'matched' is introduced (CTA 2009 s 475B).

Connected company loan relationships

Prior to accounting periods beginning on or after 1 January 2016, connected company loan relationships had to be recognised at cost (not fair value) (CTA 2009 ss 313(4), 348, 349 (prior to amendment)). Under the new s 313(4A), 'amortised cost basis' has the same meaning for tax as it has for accounting purposes. This will extend the tax consequences of notional finance charges.

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Action points

The prevalence of group and group-type arrangements means that these new measures will present a significant tax compliance challenge to many companies. An action programme would include:

- identify non-commercial loans;
- decide whether the transfer pricing rules and/or FRS 102 adjustments apply or can be excluded;
- consider the possible application of the tax transitional rules;
- track the loans carefully in future accounting periods; and
- consider how the new accounting and tax rules apply to non-commercial loans going forward. ■

For related reading visit www.taxjournal.com

- The regime TAAR for loan relationships (William Watson, 1.10.15)
- Summer Finance Bill: The debt and derivative rules (Paul Miller & James Seddon, 30.7.15)
- Modernising the tax rules for debt and derivatives (David Boneham, 12.2.15)
- The impact of FRS 102 on tax accounting (Pippa Booth & Alycia Spitzmueller, 11.4.13)