

# Loan relationships and derivative contracts: A SPRING CLEAN

*Adam Blakemore* and *Oliver Iliffe* congratulate HMRC's rewrite team on putting their house into better order

The *Corporation Tax Act* 2009 (*CTA*) received Royal Assent on 26 March this year, came into force on 1 April and has effect for accounting periods ending on or after 1 April for corporation tax (and for the tax year 2009/2010 for income tax and capital gains tax).

Whichever way it's looked at, the recently enacted *CTA* will come to be seen by practitioners as a fresh start in the development of the UK's corporation tax code. Stephen Timms, financial secretary to the Treasury, has stated that the Tax Law Rewrite Project has made the direct tax legislation 'more accessible than at any time in recent memory'. Undoubtedly there may be some who question whether, at 1,330 sections and four schedules together with 606 pages of explanatory notes (with 106 changes), this can really be a journey of tax simplification in making the legislation 'clearer and easier to use without changing the law' as explained on the Rewrite Project page of the HMRC website.

But this would be slightly unfair. As the dust of the current round of the Rewrite Project settles, practitioners can now re-engage with the legislation in its new, more open form.

The first thing that must be said, of course, is that the corporation tax code as a whole is beginning to look cosmetically very different, particularly with the final sweeping away of the schedular system with its separate cases – old friends that have been with us since the 19th century.

However, this is a rewrite programme that leaves the substance of the legislation unchanged, unless such changes have been expressly identified. Indeed, the Treasury has been granted a power at *CTA* 2009, s. 1324 to make provision by order for 'the purpose of returning the effect of the law to what it would have been' had the *CTA* not been passed, which suggests that unintended changes might be retrospectively reversed. In respect of the intended changes, companies with accounting periods straddling 1 April 2009 can make an election for the pre-*CTA* corporation tax treatment to apply in respect of a thing done or event occurring before 1 April.

Since a comprehensive review of the *CTA* in an article of this length is impossible, the authors have focused on the rewritten legislation at Parts 5, 6 and 7 of the *CTA* and, in particular, the relevant changes that have been introduced. These Parts represent a substantial consolidation of the existing loan relationships and derivative contracts codes, which, in the authors' view, improves their clarity and constitutes a logical progression for these legislative provisions.

## Parts 5, 6 and 7 of the *CTA*

The changes in Parts 5, 6 and 7 of the *CTA* are relatively few (12 of the 106 mentioned above), and are generally welcome from the point of view of

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providing greater certainty. Some of them represent a tidying-up of inconsistencies, others fix plain errors and a few more are aimed at simply ironing out the complexity of the codes as they apply in particular circumstances. The main changes are very briefly noted below.

## Tidying-up inconsistencies

The definition of 'connection' for the purposes of the loan relationships code has been clarified to apply expressly only where both relevant parties are companies. This is reflected in the drafting of *CTA* 2009, s. 466(2), which refers to their being a 'connection between a company (A) and another company (B)', whereas previously, at *Finance Act* 1996, s. 87(3), the legislation referred to 'a connection between a company and another person'. The *CTA* therefore clarifies that the use of the amortised cost basis of accounting is mandatory only in respect of loan relationships where both parties are companies. A similar change also makes it clear that deemed releases of impaired debts acquired by a company connected to the debtor company will only result where both the assignee and the assignor creditors are companies.

Any uncertainty about how reset bonds and shares with guaranteed returns are accounted for between connected parties has now been resolved, with the *CTA* giving precedence to the express requirement to fair value reset bonds or shares because of their characteristics (*CTA* 2009, s. 349(3) and 534(8)) as opposed to the express requirement to account on the amortised cost basis because of the nature of the relationship between the parties (see *CTA* 2009, s. 349(2)).

An interesting discrepancy has been corrected in relation to what did and did not qualify as a derivative contract for the purposes of the rules under *FA* 2002, Sch 26. Certain categories of contract were excluded from the derivative contracts rules because their underlying subject matter consisted of certain company shares or rights under a unit trust where various other conditions were met (*FA* 2002, Sch 26, para 4(2A) to (2D)).

Those other conditions provided that the relevant derivative contracts should be 'entered into *or acquired* by a company', whereas Sch 26, para 4(2A) provided that a contract merely needed to be entered into by a company, apparently drawing a legislative distinction between that condition and the others. The rewritten wording at *CTA* 2009, s. 591(2)(a) now refers to a 'contract entered into or acquired by a company', removing such a distinction and aligning the statutory provisions with current practice.

A change has been made to the interaction between the deemed assignment and reacquisition provisions under the derivative contracts rules to bring them more into line with the equivalent loan relationships provisions. Very broadly, a deemed assignment and reacquisition of derivative contracts takes place for a company when it ceases to be UK tax-resident or ceases to hold a derivative contract for the purposes of a UK permanent establishment (see *FA* 2002, Sch 26, para 22A) and when it has been a transferee of a derivative contract in the previous six years and leaves a group (see Sch 26, para 30A). Equivalent provisions existed for the loan relationships rules at *FA* 1996, Sch 9, para 10A and 12A, but paragraph 10A(1A) provided that paragraph 12A (transferee leaving a group) took priority where a transferee left a group and ceased to be UK-resident at the same time. No such priority previously existed for the derivative contracts rules, but has now been added as *CTA* 2009, s. 609(3).

A definition of 'impairment loss' has been added to the derivative contracts rules at *CTA* 2009, s. 702(4) in respect of the meaning of 'carrying value' of a derivative contract. The definition has been framed in the same terms as that at *FA* 1996, s. 103(1) for the loan relationships rules (now at *CTA* 2009, s. 476(1)), and this displaces the argument that 'impairment loss' otherwise takes its meaning under GAAP for derivative contracts.

## Fixing errors

A mismatch in the meaning of 'offshore fund' for the purposes of a loan relationships rule that applies when a company holds rights under a unit trust scheme or 'relevant interests' in an offshore fund (together 'relevant holdings') has been corrected. *FA* 1996, Sch 10, para 4 provided that the company's 'relevant holdings' were treated as rights under a creditor relationship and brought into account on a fair value basis if the scheme or fund failed the 'non-qualifying investments test'.

In determining whether a company had 'relevant holdings', *FA* 1996, Sch 10, para 7 provided that a 'relevant interest in an offshore fund' equated to an expanded definition of what would have been a 'material interest' in an 'offshore fund' for the purposes of *ICTA*, Part 17, Chapter 5 if offshore funds were not also required to be collective investment schemes.

However, in determining whether the fund failed the 'non-qualifying investments test' (which, very broadly, it would have done if the market value of certain interest-bearing, derivative and alternative finance assets exceeded 60% of the value of the unit trust scheme or offshore fund), the definition of 'offshore fund' took the same meaning as it did in *ICTA*, Part 17, Chapter 5 (which does require an offshore fund to be a collective investment scheme).

Since both limbs of the test had to be met for *FA* 1996, Sch 10, para 4 to apply, it was arguable that paragraph 4 could only apply where a collective investment scheme was involved. The legislation has now been changed so that the meaning of 'offshore fund' takes the wider definition (that is what would otherwise be an 'offshore fund' but for the requirement that it also be a collective investment scheme), see *CTA* 2009, s. 489(2), thus widening the scope of the rule. The Treasury's regulation-making powers have also been extended to allow it to make regulations as to what constitutes 'qualifying investments' of an open-ended investment company for the purposes of this rule.

The exclusion of debits from being brought into account where they relate to the writing down, amortisation or depreciation of a fixed capital asset or project has been tightened up. The former wording at *FA* 2002, Sch 26, para 25(4) provided that where a debit or credit is allowed by GAAP as an amount to be brought into account in determining the value of a fixed capital asset, 'no debit shall be brought into account in respect of ... so much of any amortisation or depreciation as represents a writing off of the interest component of that asset'.

This reference was arguably meaningless in a derivative contracts context, and was an error resulting from a simultaneous amendment of the loan relationships rules (*FA* 1996, Sch 9, para 14(4)(b)). The new derivative contracts wording at *CTA* 2009, s. 604(5) is clearer, removing the redundant wording referring to the 'interest component' of the asset.

## Ironing-out complexities

Deficits on loan relationships referable to basic life and general assurance business (BLAGAB) will now be carried sideways by default against income and gains referable to BLAGAB in the same period as that in which the deficit arose (see *CTA* 2009, s. 388(1)) without an election having to be made (as was previously the case at *FA* 1996, Sch 11, para 4(2)). Default carry forward will then apply for any surplus loss remaining in the usual way for BLAGAB losses.

The receipt of interest by companies in the form of funding bonds has been brought fully within the loan relationships rules with the removal of a very unlikely charge to tax under Schedule D, Case VI (itself now broadly rewritten to *CTA* 2009, Part 10, Chapter 8). The charge was only capable of applying where an issuer of a funding bond relied on the exemption from the obligation to retain funding bonds in lieu of withholding tax applied under *Income Tax Act* 2007, s. 939(2) because it was 'impracticable' to do so (see *ITA*, s. 940(1)).

It is very difficult to conceive of a scenario where the recipient of a funding bond would be both within the charge to corporation tax and the payer would be subject to a withholding obligation. HMRC suggests the example of the payment of a UK public revenue dividend under *ITA*, s. 892. Nonetheless the removal of the Case VI charge is welcome, and *CTA* 2009, s. 413(2) now has effect in relation to funding bond interest receipts, with *ICTA* 1988, s. 582(3A) having been repealed.

## Conclusion

It is almost certain that spring next year will herald a similar rewrite exercise for the remainder of the corporation tax code with Bill 6 (to be the *Corporation Tax Act* 2010). Bill 6 includes, among other things, the corporation tax computational provisions, the corporation tax reliefs and the close company rules. International provisions will follow in Bill 7, the Taxation (International and Other Provisions) Bill, which is the last of the project's major rewrite Bills and is expected in 2010. For this year, however, HMRC's rewrite team are to be congratulated on putting the house into better order, though we may feel lost in it for a short time yet.

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