*These notes refer to the Finance Act 2009 (c.10) which received Royal Assent on 21 July 2009*

# FINANCE ACT 2009

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## EXPLANATORY NOTES

## INTRODUCTION

### *Section 61 and Schedule 30: Financial Arrangements Avoidance*

### Summary

1. Section 61 and Schedule 30 contain provision to counter avoidance involving certain financial arrangements.

### Details of the Schedule

### *Paragraph 1: Interest payments: arrangements appearing very likely to produce post-tax advantage*

2. Paragraph 1 of the Schedule inserts new section 384A into the Income Tax Act 2007 (ITA). This is headed "Restriction on relief where arrangements minimise risk to borrower"

3. New subsection (1) of section 384A provides that relief will not be available for interest paid by a person on a loan if the loan is made as part of arrangements which appear very likely to produce a "post tax advantage" and the arrangements seem to have been designed to reduce any income tax or capital gains tax to which the borrower (or someone like the borrower) would be liable apart from the arrangements.

4. Subsection (2) provides that arrangements appear very likely to produce a post-tax advantage if one might reasonably assume there is no more than an insignificant risk of a 'post-tax advantage' not being produced.

5. This is a two-part test. It is firstly necessary to ascertain whether, within the meaning of the legislation, it is very likely that the incomings from the arrangements will exceed the outgoings on an after-tax basis. If that is the case then it is also necessary to ascertain whether the arrangements seem to have been designed to reduce income tax or capital gains tax liability that would have arisen independently of the arrangements. Subsection (10) explains in what circumstances arrangements are to be treated as designed to do this.

6. Subsection (3) defines what is meant by 'produce a post-tax advantage'. It means that the arrangements will produce an amount payable to the borrower or a connected person (or to someone else for the benefit of the borrower or person connected with the borrower) of an amount (or aggregate amount) that after making the appropriate tax adjustments is at least equal to the aggregate of the amount needed to meet the borrower's obligations (in respect of interest and principal) under the loan and any capital that the borrower has invested from his own resources. Where the loan is a limited recourse one the obligations may vary according to the results of the business in which it is invested.

7. "Appropriate tax adjustment" is defined in subsections (8) and (9). The adjustment ensures that the value of the tax relief for the interest (due apart from the new rule) is

taken into account in determining the amount payable to the person (and that additional tax payable by the person as a result of the arrangements is also taken into account).

8. This is intended to ensure that relief for interest is not available in any case where there is no more than an insignificant risk that the payments to which the wider scheme arrangements give rise will not produce a profit. The new measure will thus deny relief for interest if the loan is made as part of arrangements that are certain (ignoring insignificant risk) to produce a post-tax surplus for the investor by virtue of the interest being eligible for relief, provided that the arrangement seems designed to reduce tax to which the borrower would been liable apart from the arrangements. The legislation will not catch genuine commercial investments in business where there is significant uncertainty as to whether the level of return will secure a post-tax surplus for the investor.

9. Subsections (5) and (6) are anti-falsifying provisions. They ensure that the legislation will still apply if the arrangements include provision to secure that in the event of a post-tax advantage not being produced an amount not significantly less will still arise. Thus, the legislation would still apply if the arrangements gave rise to a say 30 per cent (more than insignificant) chance of a post tax advantage not being produced if in that event the investor is still certain to receive an amount not significantly less. This reflects the fact that an avoider may be willing to live with significant risk of a trivial loss if the alternative outcome is a significant post-tax profit.

10. Subsection (7) ensures that a sum is treated as payable to a person if that person directly or indirectly receives the benefit of any asset. In any such case, the sum treated as payable to the person is equal to the value of the asset.

11. Subsection (8) explains how to make the “appropriate tax adjustments” for the purpose of subsection (3) or (6). If “A” exceeds “B” the excess is to be deducted from the amount produced. If B exceeds A the excess is to be added to the amount produced.

12. Subsection (9) defines “A” and “B”. “A” is the amount of any income tax, capital gains tax or tax under the law of a territory outside the UK to which the borrower becomes liable as a result of the arrangements. “B” is the aggregate amount by which the borrower’s liability to income tax and capital gains tax would be reduced in consequence of the arrangements. This includes but is not limited to reduction in tax resulting from a claim under the interest relief provisions. For this purpose A and B are each to be computed independently of the other and it is to be assumed that relief for the interest is not blocked by subsection (1).

13. Subsection (10) explains that arrangements seem very likely to have been designed to reduce any tax liability that would arisen independently of the arrangements if and only if it would be reasonable to assume from all or any relevant circumstances that the arrangements or any part of then were so designed. This would, for instance, apply if the scheme is a marketed one and the marketing literature indicates that the arrangements are intended to reduce tax liability that would arise independently of the scheme.

14. Subsection (12) defines “related transaction” as a transaction that it would be reasonable to assume would not have been entered into or effected independently of the arrangements. Thus, a hedging agreement would be a related transaction in relation to a borrowing or investment if it would be reasonable to assume that the hedge would not have been taken out apart from the loan or investment. Similarly, anything that produces sums payable to or for the benefit of the borrower will be taken into account in determining whether a “post–tax advantage” arises provided that this is linked to the arrangements.

15. Much of the wording in the new section is taken from the “guaranteed return provisions” in sections 559 to 566 of the Income Tax (Trading and Other Income) Act 2005 (previously Schedule 5AA to the Income and Corporation Taxes Act 1988 (ICTA)).

16. Paragraph 1(2) provides that the amendment has effect in relation to interest paid on or after 19 March 2009.

### *Paragraphs 2 and 3: amounts not fully recognised for accounting purposes*

17. Paragraph 2(1) amends section 311 of the Corporation Tax Act 2009 (CTA) (loan relationships: amounts not fully recognised for accounting purposes). Section 311 deals with cases where a company is, or is treated as being party to a creditor loan relationship as respects which the company does not fully recognise all amounts in its accounts. Where the section applies the company is required to recognise for tax purposes the full amount of the credits and debits on the loan relationship.

18. Sub-paragraph (2)(a) inserts a new Condition C into section 311 so that it now applies where Condition A, B or C (not just A or B) is met.

19. Sub-paragraph (2)(b) amends section 311(2) so that it applies where an amount is not fully recognised as a result of the application of generally accepted accounting practice (GAAP) to the creditor relationship and either the relevant debtor relationship (Condition A), relevant capital contribution (Condition B) or relevant securities (new Condition C).

20. Sub-paragraph (3) amends section 311(3)(b) (Condition A) so that it refers to "the creditor relationship and debtor relationship". This is to put it beyond doubt that non-recognition of amounts in respect of the creditor relationship must be the consequence of the non-recognition of amounts in respect of the linked debtor relationship. Thus, the fact that in accordance with GAAP an amount is not recognised in respect of an unrelated debtor relationship – for instance, one used in a hedging arrangement – would not result in amounts in respect of that unrelated relationship having to be fully recognised. This reflects existing practice.

21. Sub-paragraph (4) amends section 311(4)(b) so that a similar linkage is required in respect of Condition B (capital contribution) cases.

22. Sub-paragraph (5) inserts new Condition C. This is that the company has issued securities that form part of its capital (whether or not the issuer has received cash for their issue) and an amount is not fully recognised in respect of the application of GAAP to the securities and the creditor relationship. Condition C responds to new avoidance disclosures that seek to work around section 311.

23. Sub-paragraph (6) makes a consequential amendment to section 311(6) so that in determining whether an amount is fully recognised for the purposes of section 311 regard can now be had to any securities issued by the company within sub-paragraph (5).

24. Sub-paragraph (7) provides that section 311 and 312 (amounts not fully recognised for accounting purposes) are added to the list of tax provisions that must be taken into account in calculating the carrying value of a loan relationship for the purposes of section 317(5).

25. Sub-paragraph (8) contains the commencement rule: except where sub-paragraph (9) applies the amendments have effect in relation to periods of account beginning on or after 22 April 2009.

26. Sub-paragraph (9) provides that where a period of account begins before but ends on or after 22 April the amendment operates as if one period of account ended just before that date and the other commenced on that date. This means the amendments made by paragraph 2 apply immediately in relation to the new deemed period of account (so that an immediate credit may crystallise).

27. Paragraph 3 inserts new sections 599A and 599B into Part 7 of CTA (derivative contracts). These largely reproduce for derivative contract purposes the loan

relationship rules in section 311 and 312 of CTA. They thus require full tax recognition of profits and losses in respect of a company's derivative contracts.

28. New section 599A is modelled on section 311. Section 599A(1) states that section 599B will apply for determining the debits and credits to be brought into account by a company in respect of its derivative contracts where the circumstances are as set out in section 599A(2).

29. New section 599A(2) sets out the case. A company is or is treated as party to a derivative contract and an amount is not fully recognised in respect of the derivative contract as a result of the application of GAAP to the contract and either a relevant capital contribution (Condition A) or securities issued by the company (Condition B).

30. New section 599A(3) specifies that Condition A is that an amount has been contributed to the company that forms part of its capital and an amount is not fully recognised in respect of the contribution as a result of the application of GAAP to the contribution and the contract in question.

31. New section 599A(4) is similar to section 311(5) and provides it is not necessary for an amount to form part of a company's share capital for it to be treated as a contribution to the capital of the company.

32. New section 599A(5) specifies that Condition B is that the company has issued securities that form part of its capital and an amount is not fully recognised in respect of the securities as a result of the application of GAAP to the securities and contract.

33. Section 599A(6) states that an amount is not fully recognised in respect of a contract, contribution or securities if no amount is recognised in respect of it or if amounts in respect of it are only partially recognised.

34. New section 599B(1) provides that where section 599A applies, the debits and credits to be brought into account must be determined in accordance with subsection (2).

35. Subsection (2) says that an amount in respect of the whole of the contract must be brought into account.

36. Subsection (3) provides that the debits and credits brought into account by virtue of section 599B must be determined on a fair value basis of accounting.

37. Subparagraph (2) provides that sections 599A and 599B (amounts not fully recognised for accounting purposes) are added to the list of tax provisions that must be taken into account in calculating the carrying value of a derivative contract for the purposes of section 702(3).

38. Sub-paragraph (3) contains the commencement rule: except where sub-paragraph (4) applies the amendments have effect in relation to periods of account beginning or after 22 April 2009.

39. Sub-paragraph (4) provides that where a period of account begins before but ends on or after 22 April the amendment operates as if one period of account ended just before that date and the other commenced on that date. This means the amendments made by paragraph 3 apply immediately in relation to the new deemed period of account (so that an immediate credit may crystallise).

### *Paragraph 4: Loan relationships involving connected debtor and creditor where debits exceed credits*

40. Paragraph 4(1) amends section 418 of CTA (loan relationships treated differently by debtor and creditor). Section 418 was introduced in 2008 to block schemes that involved the provision of intra-group finance through the use of convertible securities. In these schemes the debtor company sought to bring into account larger debits than the

creditor's credits as a result of the adopting of differing accounting methods in relation to the securities.

41. Sub-paragraph (2) substitutes a new section 418(1)(b). This replaces the existing Conditions A to C in section 418 with two new conditions A and B. Both conditions must be met (as well as the requirement in section 418(1) that debtor and creditor are connected) in order for the legislation to apply.

42. New subsection (2) specifies that Condition A. is that the rights under the loan relationship specified in section 418(1) include provision by virtue of which the creditor company is or may become entitled or be required to acquire (whether by conversion or otherwise) any shares in any company. This is similar to the language used in section 92 of the Finance Act (FA) 1996 before its repeal in 2005.

43. New subsection (3) specifies that Condition B is that the debits brought into account by the debtor under Part 5 of CTA in respect of the debtor relationship exceed the credits brought into account by the creditor as respects the creditor relationship when looked at for the corresponding accounting period. This test is carried out without reference to any credits the creditor may be required to bring into account under section 418.

44. The effect of new Conditions A and B is that section 418 now applies to all forms of intra-group convertible debt, not just those where the debtor divides the loan between debt and a derivative financial instrument/equity.

45. Paragraph 4 (4) inserts new subsections (6A) to (6C) into section 418.

46. New subsection (6A) provides that for the purposes of section 418 the creditor company is to be treated as party to a loan relationship notwithstanding that it has transferred those rights under a repo or stock loan (or where the transfer is by way of security under a mortgage within section 26 of the Taxation of Chargeable Gains Act 1992). This responds to avoidance disclosures that seek to disapply the legislation by means of such transactions.

47. New subsection (6B) provides that the creditor company is to be treated as remaining party to the relationship in any case not within subsection (6A) where the company disposes of the relationship with the "relevant avoidance intention".

48. New subsection (6C) defines the relevant avoidance intention as the intention of eliminating or reducing the credits to be brought into account for the purposes of Part 7.

49. Paragraph 4(5) amends subsection (7) of section 418 so that section 418A (as well as section 418) supplements section 419.

50. Paragraph 4(7) introduces new section 418A into CTA. This section ensures that the amendments made to section 418 do not prevent that section applying clearly in cases where convertible debt is in accordance with GAAP treated as divided between a host contract and a derivative financial instrument or equity instrument.

51. New section 418A(1) provides that the section applies where the debtor or the creditor company in accordance with GAAP treats the rights and liabilities under the loan as divided between rights and liabilities under a loan relation (" host contract") and a derivative financial instrument or equity instrument.

52. New section 418A(2) provides that where the debtor treats the rights and liabilities under the loan relationship in accordance with subsection (1), section 418 shall apply as if the references in section 418(3)(a) to the loan relationship were to the host contract (that is, the part of the actual loan relationship that is treated by the debtor as a loan for accounting purposes).

53. New section 418A(3) provides that where the creditor treats the rights and liabilities under the loan relationship in accordance with subsection (1), section 418 shall apply as if the references in section 418(3)(b) to the loan relationship were to the host contract

(that is, the part of the actual loan relationship that is treated by the creditor as a loan for accounting purposes).

54. Paragraph 4(8) provides that the amendments have effect for debits and credits arising on or after 22 April 2009.

### *Paragraph 5: Credits and debits for manufactured interest*

55. Paragraph 5 inserts additional wording into the rules dealing with manufactured interest payments made by companies to clarify that the payer or recipient of such amounts is generally to be taxed on them only to the extent that they are recognised in accordance with GAAP.

56. Sub-paragraph (1) inserts at the end of section 540(3) of CTA (manufactured interest treated as interest under a loan relationship for accounting periods ending on or after 1 April 2009) wording that ensures that the credits and debits to be brought into account by a payer or recipient of manufactured interest are those that are recognised under GAAP. This is subject to any other provision in the rules in Part 5 (loan relationships) or the manufactured payment unallowable purpose rule in paragraph 7A of Schedule 23A to ICTA overriding GAAP.

57. Sub-paragraph (2) inserts equivalent wording into section 97(2) of FA 1996, which is the pre-CTA version of section 540(3) of CTA for periods ending before 1 April 2009.

58. Sub-paragraph (3) contains the commencement rule, which is that it is generally to apply in relation to manufactured interest whenever paid. However, the inserted wording will not apply to manufactured interest which is treated by section 737A(5) of ICTA as paid before 27 January 2009.

## Background Note

Paragraph 1:

59. The interest relief rules encourage investment in certain small businesses carried on commercially and with a view to profit. The return on a normal investment in such a business would not be a guaranteed one such that after deducting obligations under the loan from sums to which the investment gives rise the investor was certain to be able to exit with a profit. But in schemes notified to HM Revenue & Customs (HMRC), arrangements are in place that mean that after the availability of the interest relief for the interest is taken into account the investor cannot fail to make a profit.

60. The new measure will deny relief for interest if the loan is paid as part of an arrangement that is certain (ignoring insignificant risk) to allow the investor to exit the arrangement with more money than was originally invested. It will not affect genuine commercial investments in business where there is uncertainty as to the return that will be produced from the arrangements.

Paragraphs 2 and 3:

61. Section 595 of CTA provides that the amounts to be brought into account for the purposes of derivative contracts rules in Part 7 of CTA are those that, in accordance with GAAP, are recognised in determining a company's profit or loss for the period.

62. In certain circumstances, where a derivative contract of a company is matched with shares or similar securities issued by it then it may be permissible under GAAP for the contract or amounts arising in respect of the contract not to be recognised in determining the company's accounting profits or losses for the period.

63. It is HMRC's view that such non-recognition or de-recognition is not observed for tax purposes where the accounting treatment does not fairly represent the profits. But sections 599A and 599B codify the treatment, and prevent companies arguing that where a receipt under a derivative contract is matched with the payment of a dividend

on "liabilities", there is no net liability to tax, even though no deduction is due for the dividend under the Corporation Tax Acts.

Paragraph 4:

64. In FA 2008, the Government acted to block a scheme that involved the raising of intra-group finance through the issue of convertible securities (a loan that may be converted into shares of the issuing company). The debtor company claimed for tax purposes larger debits than the credits on which the creditor company was chargeable. The legislative response was to require the creditor company to bring in additional credits equal to this excess.

65. This rule has generally been effective in countering the notified schemes but recently new schemes have been notified to HMRC that although again relying on intra-group convertibles to produce an accounting/tax mismatch, are claimed not to be countered by the 2008 fix.

66. The amendments ensure that the creditor company is required to bring into account additional credits in all cases where an intra-group loan involving convertible debt would allow the debtor company to claim debits in excess of the amounts that the creditor would otherwise have to bring into account.

Paragraph 5:

67. Paragraph 5 deals with manufactured interest payments made by companies.

68. Manufactured interest arises where under an arrangement for the transfer of debt securities (Government or corporate debt instruments) one party is required to pay to the other an amount that is representative of interest on those securities.

69. The amendments made by paragraph 5 are a response to the recent High Court case of DCC Holdings (UK) Ltd v HMRC [2008] EWHC 2429. It has been suggested that the analysis that in DCC led to the Judge allowing a deduction for a deemed section 737A of ICTA manufactured payment might lead to claims by companies for deductions for real payments of manufactured interest in excess of the amounts appearing in accounts prepared in accordance with GAAP.

70. This view appears to be based on comments in the case concerning the nature of the deemed loan relationship under which the manufactured interest is treated as payable. Some of the comments suggest the possibility that the Judge might have reached the same conclusion as to the deductibility of the manufactured interest even if a real payment had been made.

71. HMRC does not accept that this is the case, and other comments indicate that the Judge was concerned only with deemed payments, but the measure puts beyond doubt that the taxable amounts in respect of payments of manufactured interest are (subject to any express rule to the contrary) those that are recognised in accordance with GAAP. This ensures that all parties to transactions that involve the payment or receipt of manufactured interest are taxed in a fair and sensible way.