

Summary: Intervention & Options

Department /Agency: HM Revenue and Customs	Title: Impact Assessment of changes to rules on loan relationships	
Stage: Final	Version: 1	Date: 20 April 2009
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:

[Changes to Rules of Late Payments of Interest between Connected Companies](#)

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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. A consultation exercise on options for changing the rule was carried out in July 2008.

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.

Two options were proposed in a consultation document published in July 2008.

- To deny a deduction to a UK company for late interest paid to a connected creditor company where the creditor 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.

The consultation indicated that legislation based broadly on the second option would result in less impact on most companies, although respondents argued that the anti-avoidance rule would be difficult to apply and was unnecessary in the light of existing and proposed anti-avoidance measures. The Government has decided not to introduce an anti-avoidance rule, but if the relaxation of the late interest rule is abused, an anti-avoidance provision will be introduced in a future Finance Bill.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The impact of the changes to the legislation will be monitored over the next 3-5 years.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister:



Date: 20 April 2009

Summary: Analysis & Evidence

Policy Option:

Description: Disapply the current rule for most companies

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' Fewer companies will be required to make computational adjustments. There will be a one-off cost of familiarisation with the new rule. Overall the change will not have a significant impact on administrative costs for companies.
	One-off (Transition)	Yrs	
	£ negligible		
	Average Annual Cost (excluding one-off)		
	£ negligible		
Total Cost (PV)			£ negligible
Other key non-monetised costs by 'main affected groups' None.			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits 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.
	One-off	Yrs	
	£ negligible		
	Average Annual Benefit (excluding one-off)		
	£ negligible		
Total Benefit (PV)			£ negligible
Other key non-monetised benefits by 'main affected groups' None.			

Key Assumptions/Sensitivities/Risks 1. That the compliance cost of the amended rule will 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.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ negligible
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What is the geographic coverage of the policy/option?	UK wide			
On what date will the policy be implemented?	April 2009			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ 0			
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 Neg	Small Neg	Medium Neg	Large Nea
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of	£ nil	Decrease of	£ nil
Net Impact			£ 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 taxation of interest and other amounts paid and received by companies in relation to loans and other forms of corporate debt. The legislation is in the course of being rewritten in Part 5 of the Corporation Tax Bill 2009. Full guidance on the loan relationships rules can be found in HM Revenue and Customs Corporate Finance Manual. See [CFM500 - Corporate Finance home page](#).
2. The loan relationships rules apply to all companies, regardless of whether they are small, medium or large enterprises. Any change to these rules may, therefore, affect all companies within the charge to corporation tax. The rules apply only for the purposes of corporation tax and do not apply to unincorporated businesses.
3. 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.
4. 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 ('the late interest rule').
5. This rule is currently 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 (a 'paid basis'). 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.
6. One of the cases in which the late interest rule 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.
7. 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 debatable, the Government has decided to put the matter beyond doubt by amending the law.

Options for change

8. Two main options for amending the late interest rule were set out in a consultation document issued in July 2008. These options were as follows.

- i. To apply the late interest rule to all UK to UK loans between connected companies, denying a deduction in such cases regardless of whether the latter brings in credits under the loan relationships rules.
 - ii. To repeal relevant parts of the late interest rule and address the issue of asymmetry between connected debtor and creditor companies where there is late-paid interest by an anti-avoidance rule.
9. Other options such as denying 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, or taxing the interest receivable by a connected creditor company only on receipt, were also referred to in the consultation document. However, these options were not considered to be practical, or might not fully address the issue of the compatibility of the current rule with European law.
10. Thirty responses were received to the consultation. The majority of respondents were opposed to Option A (to apply the rule in UK-UK cases as well as those where the creditor is not taxed under the loan relationships rules). Arguments against the option were that it would present administrative difficulties for groups with centralised banking arrangements, would require carve-outs in a number of cases, and was inconsistent with the key principles of the loan relationships regime.
11. Option B was the preferred option for most respondents with UK-UK intra-group loans, but many were opposed to the proposal for an anti-avoidance rule. Some respondents, mainly those in groups with inward loans from foreign parent companies, argued for an election to allow companies to opt for a paid basis.
12. Respondents and other interested parties were invited to a meeting to discuss the options in November 2008, and comments made at this meeting were taken into account in developing draft legislation.

Draft legislation

13. In the light of the responses to the consultation, draft legislation was issued in December 2008. The draft legislation broadly followed the approach in option B, by disapplying the late interest rule where a debtor company is 'connected' (within the terms of the loan relationships legislation) with the creditor company, or both are 'major interest' companies, except where the creditor is located in a 'non-qualifying territory' (essentially, a tax haven), or where an anti-avoidance rule applies. This disapplication of the legislation was extended to cases where the creditor company is a close company that is also a connected or 'major interest' company, and to cases where deeply discounted securities are issued between connected companies.
14. Comments were invited on the draft legislation. Respondents argued that the anti-avoidance rule would be difficult to apply and was unnecessary in the light of existing and proposed anti-avoidance measures. The Government has decided not to introduce an anti-avoidance rule, but if the relaxation of the rule is abused, an anti-avoidance rule will be introduced in a future Finance Bill.
15. Respondents also sought the extension of the disapplication of the late interest rule to cases in which the connected creditor is a company that is a close company participator and to cases in which deeply discounted securities are issued to a company that is a close company participator, which is reflected in the draft legislation.

Impact on companies within the loan relationships rules

16. 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.

17. The proposed amendment to the legislation involves minor changes to the loan relationships rules, with which all companies are required to comply in preparing their corporation tax computations. Fewer companies will need to make computational adjustments under the amended late interest rule. In cases where the creditor is a connected company, or a 'major interest' company, or a company that is a participator in a close company, interest will be allowable on the normal loan relationships accrual basis except where the creditor is located in a 'non-qualifying territory' (a tax haven), in which case it will be allowable (as now) on a paid basis. For most companies this will represent a modest reduction in the cost of compliance.
18. There will be a negligible one-off compliance cost arising from familiarisation with the amended rules, but this will not be significant in terms of the overall impact of annual changes to tax legislation. The amendment to the legislation will provide for an election to permit the paid basis for a period after the changes, to allow companies time to adjust to the new rule.

Impact on small firms

19. 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.
20. 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.

Competition Assessment

21. 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

22. The proposals for amending the late interest rule affect only companies and will have no impact on Legal Aid.

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

23. The proposals for amending the late interest rule 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

24. The proposals for amending the late interest rule 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

25. The proposals for amending the late interest rule affect only the computation of corporation tax liabilities of companies and will neither impact on nor be impacted on by rural proofing.

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

Annexes