

# CORPORATION TAX ACT 2010

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## EXPLANATORY NOTES

### INTRODUCTION

#### **Part 16: Factoring of income etc**

##### **Overview**

2278. This Part rewrites sections 774A to 774G and 786 of ICTA (for the purposes of corporation tax) and paragraphs 1 to 6 of Schedule 25 to FA 2009.
2279. Chapter 1 of this Part (transfers of income streams) is based on paragraphs 1 to 6 of Schedule 25 to FA 2009. Chapter 2 of this Part (finance arrangements) is based on sections 774A to 774G of ICTA. Chapter 3 of this Part (loan or credit transactions) is based on section 786 of ICTA.
2280. Paragraph 7 of Schedule 25 to FA 2009 inserted Chapter 5A of Part 13 of ITA, which makes provision for income tax corresponding to Chapter 1 of this Part. Sections 774A to 774G and 786 of ICTA are rewritten for income tax purposes in Chapters 5B and 5C of Part 13 of ITA. These Chapters are inserted by Schedule 5 to TIOPA. See the commentary on that Schedule.

#### **Chapter 1: Transfers of income streams**

##### **Overview**

2281. This Chapter is concerned with transfers of income streams. It is based on paragraphs 1 to 6 of Schedule 25 to FA 2009.

##### ***Sections 752 to 757: Application of Chapter; value of transferred income treated as income; exception: amount otherwise taxed; exception: transfer by way of security; partnership shares; interpretation***

2282. These sections are concerned with transfers of income streams. They are based on paragraphs 1 to 6 of Schedule 25 to FA 2009. They replicate the source legislation, except in two respects.
2283. First, the statutory references have been updated. In consequence, section 755 (exception: transfer by way of security) is worded differently from the source legislation, paragraph 4 of Schedule 25 to FA 2009. But it has the same effect.
2284. Second, section 757 (interpretation) omits the express Scottish modifications in the source legislation, paragraph 6 of Schedule 25 to FA 2009, because section 1166(1) provides that in the application of the Corporation Tax Acts to Scotland “assignment” means assignation and “surrender” includes renunciation.

## **Chapter 2: Finance arrangements**

### **Overview**

2285. This Chapter is based on sections 774A to 774G to ICTA (structured finance arrangements). It stops a number of schemes which are intended to enable taxpayers to borrow money and obtain effective tax relief for both interest and repayment of principal.
2286. A “finance arrangement”, within this Chapter, is an arrangement where in accordance with GAAP a person (“the borrower”) records in its accounts a financial liability in respect of a sum (“advance”) paid by “the lender”, and that sum is paid to acquire assets (for example an income stream), which will be used to repay the advance.
2287. Where there is a finance arrangement which would have had the effect that either:
- income or receipts that would have been brought into account by the borrower for tax purposes, but for this arrangement, are not brought into account; or
  - the borrower would have become entitled to a deduction in computing its income or profits for tax purposes,
- then
- the finance arrangement does not have that effect, with the result that the income from the transferred asset continues to be taxed on the borrower; and
  - any disposal or reacquisition of the asset is disregarded for the purposes of TCGA.
2288. Corporation tax relief is allowed for the amount of any interest or “finance charge” in respect of the finance agreement shown in the borrower’s accounts. This amount is treated as interest payable on a debtor loan relationship to which it is party.
2289. This Chapter has the following structure.
- Sections 758 to 762 deal with “type 1 finance arrangements”: the simple case, not necessarily involving a partnership.
  - Sections 763 to 766 deal with “type 2 finance arrangements”: the first of two complex partnership cases.
  - Sections 767 to 769 deal with “type 3 finance arrangements”: the second of two complex partnership cases.
  - Sections 770 to 773 make exceptions to these rules.
  - Sections 774 to 776 are interpretative.

### **Section 758: Type 1 finance arrangement defined**

2290. This section defines a form of arrangement, labelled a “type 1 finance arrangement”, which falls within this legislation. It is based on section 774A of ICTA.
2291. *Subsection (1)* provides that two conditions must be met if an arrangement is to be a type 1 finance arrangement.
2292. The word “arrangement” appears in subsection (1) for the first time in this Chapter. See section 775.
2293. *Subsection (2)* specifies condition A, which concerns the terms of the arrangement. There are three tests in condition A, all of which must be passed if the condition is to be met. To summarise:
- A borrower must “receive” an advance from a lender;

*These notes refer to the Corporation Tax Act 2010  
(c.4) which received Royal Assent on 3 March 2010*

- the borrower (or a person “connected” with the borrower) must “dispose” of an asset (the security) to, or for the benefit of, a lender (or a person “connected” with the lender); and
  - the lender (or a person “connected” with the lender) must be entitled to “payments in respect of” the security.
2294. An ordinary secured loan would not be a type 1 finance arrangement, because it would not satisfy subsection (2)(b) or, if it did, it would not satisfy subsection (2)(c).
2295. The first reference in this Chapter to a person receiving an asset is in subsection (2)(a). See section 776(2).
2296. Subsection (2)(b) is the first of a number of provisions in this Chapter which refer to persons being “connected”. The meaning of “connected” in those provisions is given by section 1176(1). Section 774G(4) of ICTA is therefore not rewritten as a separate proposition.
2297. The first reference in this Chapter to a disposal of an asset is in subsection (2)(b). See section 776(3).
2298. The first reference in this Chapter to payments in respect of an asset is in subsection (2)(c). See section 776(4).
2299. *Subsection (3)* specifies condition B, which is about accounting. To summarise, the payments mentioned in subsection (2)(c) must be, for accounting purposes, payments of principal rather than interest.
2300. The first reference in this Chapter to a person’s accounts is in subsection (3)(a). See section 774(2) and (4).
2301. The first reference in this Chapter to an amount being recorded in accounts as a financial liability is in subsection (3)(a). See section 774(3).

***Section 759: Certain tax consequences not to have effect***

2302. This section disapplies certain tax consequences of a type 1 finance arrangement if certain conditions are met. It is based on sections 774A(4), 774B(1), (1A) and (2) to (4) and 774G(2) of ICTA.
2303. Under *subsections (1) and (2)*, if – but for this section – a type 1 finance arrangement would have the “relevant effect”, then it does not.
2304. *Subsection (3)* defines the “relevant effect”, and *subsection (4)* defines the “relevant effect” if the borrower is a partnership. Each of those subsections specifies three alternative effects.

***Section 760: Payments treated as borrower’s income***

2305. This section treats the payments mentioned in section 758(2)(c) as income of the borrower. It is based on sections 774A(4), 774B(1) and (1B) to (3) and 774G(2) of ICTA.
2306. Under *subsection (1)*, this section only applies if:
- there is a type 1 finance arrangement;
  - section 759(2) and the corresponding income tax provision do not stop this arrangement having the relevant effect because it would not have the relevant effect in the first place; and

- the borrower is either (a) a company within the charge to corporation tax or (b) a partnership at least one member of which is a company within the charge to corporation tax.

***Section 761: Deemed loan relationship if borrower is a company***

2307. This section brings the loan relationship provisions into play if there is a type 1 finance arrangement and the borrower is a company. It is based on section 774B(5), (7) and (8) of ICTA.
2308. If there is a type 1 finance arrangement and the borrower is a company, then either section 759 prevents it having the relevant effect in relation to the company, in which case *subsection (1)(c)(i)* applies this section, or else section 760 applies to the company, in which case *subsection (1)(c)(ii)* applies this section.
2309. *Subsection (2)* applies the loan relationship provisions of CTA 2009 to the company mentioned in subsection (1), deeming the advance to be a money debt owed by the company and the arrangement to be a debtor relationship of the company. “Money debt” and “debtor relationship” have the meanings given by, respectively, sections 303 and 302(6) of CTA 2009.
2310. Under *subsection (3)*, any finance charge recorded in the company’s accounts is deemed to be interest payable under the deemed loan relationship.
2311. If subsection (3) deems there to be interest payable, *subsection (4)* determines when it is deemed to be paid.

***Section 762: Deemed loan relationship if borrower is partnership with corporate member***

2312. This section brings the loan relationship provisions into play if there is a type 1 finance arrangement and the borrower is a partnership with at least one corporate member. It is based on section 774B(5) to (8) of ICTA, and has a similar structure to section 761. See the commentary on that section.

***Section 763: Type 2 finance arrangement defined***

2313. This section defines a form of arrangement, labelled a “type 2 finance arrangement”, which falls within this legislation. It is based on section 774C(1) to (3) of ICTA.
2314. A type 2 finance arrangement works like this.
- Under the arrangement, a transferor disposes of an asset to a partnership.
  - This partnership is one of which the transferor is a member immediately after that disposal – it does not matter whether it was a partner before the disposal.
  - The partnership receives an advance from a lender.
  - The accounts of the partnership record in accordance with GAAP for that period a financial liability in respect of the advance.
  - There is a “relevant change” in relation to the partnership. Broadly speaking, a “relevant change” affects the lender. Either the lender (or a person connected with the lender) becomes a member of the partnership, or else there is a change in the profit share of the lender (or of a person connected with the lender). See section 764.
  - The share of the lender (or other person involved in the relevant change) in the profits of the partnership is determined (wholly or partly) by reference to payments in respect of the asset disposed of.
  - In accordance with GAAP the payments reduce the amount of the financial liability.

2315. The lender's advance is thus made in the form of a contribution to the partnership and its profit share is such that payments are made to it which repay that contribution together with interest. Once the repayment with interest has been made it is likely that there are arrangements under which the lender ceases to be a member of the partnership or to share in the profit of it.
2316. If the relevant change would (but for section 765) have the "relevant effect" (as defined in subsection (3) of that section), then that section negates the relevant effect.
2317. *Subsection (1)* provides that two conditions must be met if an arrangement is to be a type 2 finance arrangement.
2318. *Subsection (2)* specifies condition A, which concerns the terms of the arrangement. There are five tests in condition A, all of which must be passed if the condition is to be met.
2319. *Subsection (3)* specifies condition B, which is about accounting. To summarise, the payments mentioned in subsection (2)(e) must be, for accounting purposes, payments of principal rather than interest.

#### ***Section 764: Relevant change in relation to partnership***

2320. This section defines "relevant change". It is based on section 774C(2), (4), (6) and (7) of ICTA.
2321. This section applies for the purposes of this Chapter and, therefore, is used in defining both "type 2 finance arrangement" and "type 3 finance arrangement". See sections 763(2)(d) and 767(2)(c).
2322. *Subsection (5)* defines "person involved in a relevant change" for the purposes of this Chapter.

#### ***Section 765: Certain tax consequences not to have effect***

2323. This section disapplies certain tax consequences of a type 2 finance arrangement if certain conditions are met. It is based on sections 774D(1) to (4) and 774G(2) of ICTA.
2324. Under *subsections (1)* and (2), if – but for this section – a relevant change in relation to the partnership would have the "relevant effect", then it does not.
2325. *Subsection (3)* defines the "relevant effect". It specifies three alternative effects.

#### ***Section 766: Deemed loan relationship***

2326. This section brings the loan relationship provisions into play if there is a type 2 finance arrangement. It is based on section 774D(7), (8), (12) and (13) of ICTA.
2327. *Subsection (2)* has the effect of deeming a loan relationship to exist for the purposes of Part 5 of CTA 2009. The wording of subsection (2) chimes with the definition of "loan relationship" in section 302(1) of CTA 2009 to define a loan relationship. See also Chapter 9 of Part 5 of CTA 2009 (loan relationships: partnerships involving companies).
2328. Under *subsection (3)*, any finance charge recorded in respect of the advance in the partnership's accounts is deemed to be interest payable under the deemed loan relationship.
2329. If subsection (3) deems there to be interest payable, *subsection (5)* determines when it is deemed to be paid.

#### ***Section 767: Type 3 finance arrangement defined***

2330. This section defines a form of arrangement, labelled a "type 3 finance arrangement", which falls within this legislation. It is based on section 774C(1), (4) and (5) of ICTA.

2331. A type 3 finance arrangement is similar to a type 2 finance arrangement. See the commentary on section 763. A type 3 finance arrangement, however, deals with a casewhere an existing partnership enters into an arrangement underwhich the lender becomes a partner and shares in the profits to anextent sufficient to repay its contribution with interest. It differsfrom a type 2 finance arrangement in that (a) the partnership cannot be one formed for the purposes of the arrangement and (b) there is no reference to a transfer of an asset or a transferor.
2332. *Subsection (1)* provides that two conditions must be met if an arrangement is to be a type 3 finance arrangement.
2333. *Subsection (2)* specifies condition A, which concerns the terms of the arrangement. There are four tests in condition A, all of which must be passed if the condition is to be met.
2334. *Subsection (3)* specifies condition B, which is about accounting. To summarise, the payments mentioned in subsection (2)(d) must be, for accounting purposes, payments of principal rather than interest.
2335. Conditions A and B in this section are very similar to conditions A and B in section 763 (type 2 finance arrangement defined). For the provisions which differ, see sections 763(2)(a) and (b) and 767(2)(a).

***Section 768: Certain tax consequences not to have effect***

2336. This section disapplies certain tax consequences of a type 3 finance arrangement if certain conditions are met. It is based on sections 774D(1) to (4) and 774G(2) of ICTA.
2337. Under *subsections (1)* and (4), if – but for this section – a relevant change in relation to the partnership would have the “relevant effect”, then it does not.
2338. *Subsection (2)* defines the “relevant effect”. It specifies three alternative effects. The “relevant effect” in subsection (2) is very similar to the “relevant effect” in section 765(3), which makes corresponding provision for type 2 finance arrangements. But the “relevant effect” in subsection (2) is an effect on a “relevant member” (as defined in *subsection (3)*), whereas the “relevant effect” in section 765(3) is an effect in relation to the transferor.

***Section 769: Deemed loan relationship***

2339. This section brings the loan relationship provisions into play if there is a type 3 finance arrangement. It is based on section 774D(3) and (10) to (13) of ICTA.
2340. This section is very similar to section 766. But this section focuses on a “relevant member” (as defined in *subsection (6)*), whereas section 766 focuses on the transferor.

***Section 770: Exceptions: preliminary***

2341. This section introduces a group of sections which make exceptions to sections 758 to 769. It is new.

***Section 771: Exceptions***

2342. This section specifies exceptions to sections 758 to 769. It is based on section 774E(1) to (6) of ICTA.
2343. *Subsection (6)* refers to Part 10A of ITA (alternative finance arrangements), which is inserted by Schedule 2 to TIOPA and is based on Chapter 5 of Part 2 of FA 2005.



**Section 772: Exceptions: relevant person**

2344. This section defines “relevant person” for the purposes of section 771. It is based on section 774E(7) of ICTA.
2345. Section 774E of ICTA contains priority rules which prevent sections 774B and 774D of ICTA applying if other tax enactments apply. The definition of “relevant person” in section 774E(7) of ICTA interprets the references to a relevant person in section 774E(1) and (3) of ICTA. The wider the meaning of “relevant person”, the more likely it is that section 774E(1) and (3) of ICTA disapply the anti-avoidance rules in sections 774B and 774D of ICTA. The only possibly uncertain element of the meaning of “relevant person” is the reference to a person connected with the borrower. Section 774G(4) of ICTA provides that the definition of “connected” in section 839 of ICTA applies “for the purposes of sections 774A to 774D”. It is not clear whether the use of “connected” in section 774E(7) of ICTA can be said to be “for the purposes of sections 774A to 774D”. But it is at any rate clear that section 774E only operates effectively as a priority rule if, at the very least, the reference in section 774E(7) of ICTA to persons connected with the borrower includes all persons who as a result of section 839 of ICTA would be treated as connected to the borrower. Whether the reference goes (or needs to go) wider than that group is open to argument. The inclusive definition in *subsection (5)* preserves the scope for making that argument while giving the maximum possible certainty.

**Section 773: Power to make further exceptions**

2346. This section enables the Treasury to make further exceptions to sections 758 to 769. It is based on section 774F of ICTA.

**Sections 774 to 776: Accounts; arrangements; assets**

2347. These interpretative sections are based on section 774G(1), (3) and (5) to (6) of ICTA.

**Chapter 3: Loan or credit transactions**

**Overview**

2348. This Chapter is based on section 786 of ICTA. It deals with certain loan or credit transactions.

**Section 777: Loan or credit transaction defined**

2349. This section defines “loan or credit transaction” for the purposes of sections 778 and 779. It is based on section 786(1) and (2) of ICTA.
2350. What is now section 786 of ICTA originally appeared as paragraph 12 of Schedule 13 to FA 1969. It is aimed at artificial arrangements for dressing up payments of interest in another form – for example, arrangements whereby X grants Y an interest-free loan and:
- Y grants X an annuity while the loan is outstanding; or
  - Y transfers income-bearing assets to X on the understanding that X will return them when the loan is paid off.
2351. *Subsection (1)* states the scope of the definition.
2352. *Subsections (2) and (3)* focus on, respectively, the lending of money and the giving of credit.
2353. *Subsections (4) and (5)* supplement subsections (2) and (3) respectively.

***Section 778: Certain payments treated as interest***

2354. This section deems annual payments under loan or credit transactions to be interest. It is based on section 786(3) and (3A) of ICTA.
2355. For corporation tax purposes, the word “annual” adds nothing to the sense of “annual interest” in section 786(3) of ICTA. It is therefore not rewritten in *subsection (2)*.

***Section 779: Tax charged on income transferred***

2356. This section imposes a charge to corporation tax in certain cases in which, under a loan or credit transaction, a company transfers income arising from property without a sale or transfer of the property. It is based on section 786(5) to (7) of ICTA.
2357. *Subsection (1)* states when this section applies.
2358. *Subsection (2)* imposes the charge to corporation tax on income and quantifies the amount taxable.
2359. *Subsections (3) to (7)* are supplementary.