DRAFT GUIDANCE: CORPORATION TAX TREATMENT OF INTEREST-FREE LOANS AND OTHER NON-MARKET LOANS

Terminology

There currently exists a suite of accounting standards in the UK. Subject to certain restrictions detailed in the respective standards themselves, UK companies may choose or may be required to prepare their accounts under one of the following:

- **EU-endorsed IFRS/IAS:** those accounts prepared in accordance with International Accounting Standards within the meaning of s395 of the Companies Act. Hereafter 'IFRS' for the purposes of this draft guidance:
- **New UK GAAP** - FRS 100, FRS 101 and FRS 102. Entities applying New UK GAAP will, within the framework of FRS 100, apply one of the following:
    - **FRS 101** - effectively the recognition and measurement requirements of IAS subject to some adjustments to ensure alignment with UK Companies Act and also reduced disclosure requirements.
    - **FRS 102** - a new suite of accounting requirements which are closely aligned to, but are not the same as, IFRS.
    - **Section 1A of FRS 102** - available to small companies, is aligned to FRS 102 but with reduced disclosures and presentation requirements.

  Hereafter 'New UK GAAP' for the purposes of this draft guidance.
- **Old UK GAAP:** substantively the FRS's, SSAP's, UITF's and relevant accepted practice in existence and applied prior to the introduction of New UK GAAP. For the avoidance of doubt this draft guidance includes FRS26[1] (and related standards) within its meaning of Old UK GAAP unless otherwise specifically stated. For purposes of this draft guidance this is described as 'Old UK GAAP'.
- **FRSSE:** the Financial Reporting Standard for Smaller Entities. Companies that meet the eligibility criteria may prepare and file abbreviated accounts.
- **Micro entities:** Companies that meet the eligibility criteria may prepare and file abridged accounts.

For periods commencing on or after 1 January 2015 medium and large companies will not be permitted to prepare their accounts in accordance with Old UK GAAP. Instead companies which applied Old UK GAAP will need to change to one of the alternatives. It is expected that many will change to New UK GAAP, applying either FRS 101 or FRS 102.

For periods commencing on or after 1 January 2016 small companies will no longer be permitted to prepare their accounts in accordance with the FRSSE. Instead they will need to change to one of the New UK GAAP alternatives. It is expected that most companies currently applying FRSSE will change to Section 1A of FRS 102.

[1] FRS 26 (Financial instruments: recognition and measurement) was introduced in 2005 and is aligned to the requirements of IAS 39. It was mandatory for companies with listed debt or equity that are not using IFRS, and those companies which took the option to use fair value accounting that is part of UK company law.

CFM33172: GAAP: Interest-free loans and other non-market loans

In 2015 and 2016 many UK companies will be required to adopt new accounting standards. In particular, in 2015 all medium and large companies will be required to apply one of EU-endorsed IFRS, FRS 101 and FRS 102 while in 2016 small companies will be expected to apply FRS 102 (either in full or under Section 1A). In each case the requirements for financial instruments under the new accounting standards will differ from that under Old UK GAAP (where FRS 26 has not been applied).

One particular area where there can be significant difference from Old UK GAAP (where FRS 26 has not been applied) is in respect of non-interest bearing loans and in other cases where loans are entered into on non-market terms. For example a shareholder may lend money to a company but not charge any interest.

The accounting difference arises from the requirement in Section 11 of FRS 102 that a basic financial instrument should, in the case of a financing transaction, be measured on initial recognition in the accounts at the present value of future expected cash flows. This is similar to the requirement in Section 12 of FRS 102 that non-basic financial instruments (and in IAS 39 for all financial instruments), that they be measured on initial recognition at the fair value of the instrument.

In most cases, the transaction price for entering into the financial instrument will be the same as its present value / fair value. However, in cases where the loan is not entered into on market terms, this is likely to lead to an accounting difference being booked on inception.

There are a number of accounting and tax rules that can be relevant, depending on the nature of the transaction. This section of the guidance looks to cover the interaction of those rules and explain how this particular accounting issue should be treated for corporation tax purposes in the most common circumstances.

See the example CFM33173.

CFM33173: GAAP: Interest-free loans and other non-market loans

Example

A shareholder lends £100,000 to B Ltd, a UK company, on 1 January 2015. The loan is interest free and is repayable on 1 January 2016. It is assessed the market rate at which B Ltd can borrow is 10% per annum (this is therefore the rate used to discount the cash flows of the loan).

Accounting by B Ltd - year ended 31 December 2015

Initial recognition:

Dr Cash (balance sheet)	£100,000	
Cr Loan liability (balance sheet)		£90,909
Cr Capital contribution (Equity)		£9,091

Effective interest accrual:

Dr Finance expense (P&L)	£9,091	
Cr Loan liability (balance sheet)		£9,091

(The numbers in this example are used to illustrate the technical points. The precise accounting amounts would need to be calculated by the company.)

In this example, the accounting difference of £9,091 is credited direct to B Ltd's equity as a capital contribution. This recognises the fact that by lending to the company at below the market rate, the shareholder is effectively contributing value to it.

As noted above, companies do not normally enter into financial instruments on non-market length terms. Careful consideration of the facts is therefore needed to ascertain what transaction is taking place and how it should be treated both for accounting and tax purposes.

This type of situation often arises where there is some connection between the lender and the borrower. There are tax rules which therefore need to be considered, particularly the connected company rules under the loan relationship regime (see CFM 35000) and the transfer pricing rules (see INTM 410000).

The guidance at CFM33174 onwards addresses some of the most common situations.

Proposed changes to the rules for loans and derivatives

Note that the government has proposed changes to the taxation of loans and derivatives, which could impact on the treatment of financial instruments entered into on non-market terms. The guidance will be updated to take account of those changes once they have been enacted.

In particular, the proposed amendments will link the corporation tax treatment to the amounts recognised in profit or loss. Amounts relating to new instruments recognised in equity will not typically be brought into account for tax. In addition, the definition of amortised cost basis of accounting which is required for connected company loans is being aligned with the accounting definition for new instruments. It is proposed that the new rules will apply for accounting periods commencing on or after 1 January 2016.

CFM33174: GAAP: Interest-free loans and other non-market loans: connected companies

CFM33172 explains the accounting issues that arise in respect of interest-free loans and other non-market loans following the adoption of new accounting standards in 2015 and 2016. The most common example is where a loan is between connected companies. The loan relationship provisions contain specific rules which mandate the accounting treatment which is used for tax purposes when a loan is between connected companies. In many cases this will align the treatment with the Old UK GAAP position.

See CFM35190 for further details of how the connected company rules apply to these type of instruments.

CFM33175: GAAP: Interest-free loans and other non-market loans: loan from shareholder

The accounting issue explained in CFM33172 may also arise where a company has borrowed from an individual who is a shareholder in the company. The tax treatment of the loan will depend on whether the company applied Old UK GAAP (excluding FRS 26) or New UK GAAP / FRS 26 / IFRS at the time the loans were advanced.

Similar issues will arise where a company has borrowed from a corporate shareholder that is not a connected company under the loan relationship rules.

See CFM33176 for an example where the company applied Old UK GAAP (excluding FRS 26) on inception of the loan.

See CFM33177 for an example where the company applied New UK GAAP on inception of the loan.

See CFM33178 for examples where the transfer pricing rules are applicable.

CFM33176: GAAP: Interest-free loans and other non-market loans: loan from shareholder: loans made under Old UK GAAP (excluding FRS 26)

Where the loan was made at a time when the company applied Old UK GAAP (without FRS 26) the accounting issue typically surfaces on transition to the new accounting standards. This is when it would become relevant for tax. So where, on transition, there is a reduction in the carrying value of the liability of the company this will result in a taxable credit being brought into account under section 316 CTA 2009. On the assumption that the loan falls to be repaid after the end of the accounting period, the credit will be brought into account for tax purposes over a period of ten years under the COAP Regulations. See CFM76000 for further details of these rules.

Example

A shareholder lends £100,000 to B Ltd, a UK company, on 1 January 2014. The loan is interest free and is repayable on 1 January 2019. It is assessed the market rate at which the company can borrow is 10% per annum (this is therefore the rate used to discount the cash flows of the loan).

B Ltd has sufficient borrowing capacity to be able to borrow £100,000 on an arm's length basis (so is not thinly capitalised).

No other consideration is paid or transaction entered into between the two parties.

(The numbers in this example are used to illustrate the technical points. The precise accounting amounts would need to be calculated by the company.)

Accounting by B Ltd - year ended 31 December 2014 (applies Old UK GAAP)

Dr Cash (balance sheet)	£100,000	
Cr Loan liability (balance sheet)		£100,000

No amounts are recognised to profit or loss in the accounts. No amounts are therefore brought into account for tax.

Restatement on transition to New UK GAAP

Dr Loan liability (balance sheet)	£31,699	
Cr Retained earnings (equity)		£31,699
The restated value of the loan liability is therefore (as at 1/1/15)		£68,301

Accounting by B Ltd - year ended 31 December 2015 (applies New UK GAAP)

Dr Finance expense (P&L)	£6,830	
Cr Loan liability (balance sheet)		£6,830

Tax analysis:

A transitional adjustment of £31,699, a credit, being the difference between the £100,000 previously recorded and the new carrying value of £68,301, will be brought into account by B Ltd over 10 years (£3,170 each year). In 2015, B Ltd will bring into account a net debit of £3,660 (finance expense of £6,830 less transitional credit of £3,170).

Over the course of the loan term the loan will accrete to its maturity value and therefore B Ltd will bring into account the same amount of debits (the total finance expense recognised) and credits (the amount recognised in reserves), reflecting that it has no overall profit or loss from the loan relationship.

CFM33177: GAAP: Interest-free loans and other non-market loans: loan from shareholder: loans made under New UK GAAP

Where the loan was made under New UK GAAP the accounting issue arises from inception. The corporation tax treatment will be based on the amounts recognised in the company's accounts.

Example

A shareholder lends £100,000 to B Ltd, a UK company, on 1 January 2015. The loan is interest free and is repayable on 1 January 2020. It is assessed the market rate at which B Ltd can borrow is 10% per annum (this is therefore the rate used to discount the cash flows of the loan).

B Ltd has sufficient borrowing capacity to be able to borrow £100,000 on arm's length basis (so is not thinly capitalised).

No other consideration is paid or transaction entered into between the two parties.

Accounting by B Ltd - year ended 31 December 2015 (New UK GAAP)

Dr Cash (balance sheet)	£100,000	
Cr Capital contribution (equity)		£37,908
Cr Loan liability (balance sheet)		£62,092
Dr Finance expense (P&L)	£6,209	
Cr Loan liability (balance sheet)		£6,209

(The numbers in this example are used to illustrate the technical points. The precise accounting amounts would need to be calculated by the company.)

Tax analysis:

The capital contribution of £37,908 will be recognised in B Ltd's statement of changes in equity and the finance expense of £6,209 will be recognised in its income statement. Both amounts arise in respect of a loan relationship and should be brought into account under sections 307 and 308 CTA 2009.

Over the course of the loan term, B Ltd will bring into account the same amount of debits and credits, reflecting that it has no overall profit or loss from the loan relationship.

CFM33178: GAAP: Interest-free loans and other non-market loans: interaction with transfer pricing

The analysis in CFM33174 assumes that there is no application of the transfer pricing rules. There are two potential aspects that can often arise. These are:

- The imputation of interest – see CFM33178a.
- Thin capitalisation – see CFM33178b.

CFM33178a: GAAP: Interest-free loans and other non-market loans: interaction with transfer pricing: imputation of interest

A UK shareholder may be required under transfer pricing rules to impute interest income on loans that are made at a below market interest rate. In such a case, a UK borrower may be entitled to claim a compensating adjustment. This may affect the resulting accounting and tax treatment applicable to the borrower, because UK tax legislation and OECD guidance treat the claimant company as having its accounts re-written to reflect the arm's length position. This is likely to restore the borrower to the position it would have been in had it borrowed on arm's length terms.

Example (interest-free debt, borrower is not thinly capitalised)

A UK shareholder lends £100,000 interest free to B Ltd, a UK company, on 1 January 2015, repayable on 1 January 2020. It is assessed the market rate at which B Ltd can borrow is be 10% per annum (this is therefore the rate used to discount the cash flows of the loan).

No other consideration is paid and no other transaction entered into between the two parties. B Ltd is not a small or medium sized enterprise, and a transfer pricing adjustment is made by the shareholder to recognise interest income of £10,000.

Accounting by B Ltd - year ended 31 December 2015 (New UK GAAP)

Dr Cash (balance sheet)	£100,000	
Cr Capital contribution (equity)		£37,908
Cr Loan liability (balance sheet)		£62,092
Dr Finance expense (P&L)	£6,209	
Cr Loan liability (balance sheet)		£6,209

(The numbers in this example are used to illustrate the technical points. The precise accounting amounts would need to be calculated by the company.)

Tax analysis:

The shareholder imputes interest income of £10,000 per annum under transfer pricing. If B Ltd claims a compensating adjustment, it will calculate its profits and losses for tax purposes as if it had entered into an interest bearing loan (the arm's length provision) and simply recognise an adjustment in its tax computation to recognise a total interest expense of £10,000. B Ltd has recognised a finance expense of £6,209, so the 2015 tax computation will reflect a further deduction of £3,791 (£10,000 less £6,209).

The same analysis will apply to the lender where it is a UK-resident company; the lender will be an advantaged person for each period over the term of the debt. As such, it will calculate its profits for tax purposes on the basis that it has an interest bearing loan bring the interest income of £10,000 into account in line with the accounting and tax treatment that would apply to an interest bearing loan.

CFM33178b: GAAP: Interest-free loans and other non-market loans: interaction with transfer pricing: thin capitalisation

A loan from a related party lender may be greater than a corporate borrower can obtain from an arm's length lender. To reflect the arm's length provision, the borrower is assumed to borrow a lower amount (or no amount at all) for periods in which the arm's length provision is required to be applied.

Note that the accounting analysis under New UK GAAP may be different to the transfer pricing analysis. The accounting analysis does not take into account what amount the company could or would have borrowed in the absence of the special relationship with the related party lender; it simply looks to discount the expected cash flows by the market interest rate. The carrying value of the loan will then accrete up to the full amount repayable on redemption, with corresponding amounts recognised in profit or loss. The amounts recognised in profit or loss may therefore exceed the amounts which, under a transfer pricing analysis, would have been incurred had the parties been acting at arm's length.

The interest charged on a loan may be correctly priced commercially, or put on market terms by the action of New UK GAAP, but that does not mean the amount borrowed is what the borrower could or would have borrowed at arm's length.

Example (interest-bearing debt, 5 year term, borrower is thinly capitalised)

An overseas shareholder lends £100,000 at 10% to B Ltd, a UK company, on 1 January 2014, repayable on 1 January 2019. B Ltd has insufficient assets or cash flow to support the whole of this loan. As a consequence it is assessed the market rate of interest for this debt is estimated to be 15% (this is therefore the rate used to discount the cash flows of the loan).

The arm's length terms for this debt are that B Ltd would only have been able to borrow – or would have only chosen to borrow, £60,000 at an interest rate of 10%, resulting in an arm's length expense of £6,000. B Ltd is not a small or medium sized enterprise.

Accounting by B Ltd – year ended 31 December 2014 (applies Old UK GAAP)

Dr Cash (balance sheet)	£100,000	
Cr Loan liability (balance sheet)		£100,000
Dr Finance expense (P&L)	£10,000	
Cr Cash (balance sheet)		£10,000

A finance expense of £10,000 is recognised in profit or loss for the period. This gives rise to a potential UK tax advantage in this period because the accounting expense is greater than the arm's length expense. A transfer pricing adjustment is therefore made to disallow £4,000 (finance expense of £10,000 less arm's length expense of £6,000).

Restatement on transition to New UK GAAP

Dr Loan liability(balance sheet)	£14,275	
Cr Retained earnings (equity)		£14,275

The restated value of the loan liability is therefore (as at 1/1/15) £85,725.

Accounting by B Ltd - year ended 31 December 2015 (applies New UK GAAP)

Dr Finance expense (P&L)	£12,859	
Cr Cash (balance sheet)		£10,000
Cr Loan liability (balance sheet)		£2,859

(The numbers in this example are used to illustrate the technical points. The precise accounting amounts would need to be calculated by the company.)

Tax analysis

Absent transfer pricing, the transition to New UK GAAP will result in a transitional adjustment in B Ltd of £14,725 (£100,000 less £85,725). For tax purposes this is spread over 10 years, so a credit of £1,473 would be recognised in each of the affected tax computations.

In addition, a finance expense of £12,859 is recognised in profit or loss, so overall in 2015 B Ltd would bring into account a net debit of £11,386 (£12,859 finance expense less transitional credit of £1,473).

However in the absence of the special relationship B Ltd could only have borrowed £60,000 at an interest rate of 10% resulting in an arm's length expense of £6,000. Since a potential UK tax advantage exists, B Ltd must recognise a transfer pricing adjustment to place the loan on arm's length terms and thereby reduce its interest expense to £6,000. This results in a net thin capitalisation restriction of £5,386 (£11,386 less £6,000). A similar analysis applies for years through to 2019.

The loan is repaid at the start of 2019 and there are no more accounting debits in profit or loss. The only amounts that are potentially required to be brought into account for tax purposes are the ten year spreading of the transitional adjustment (£1,473 per annum in this example). There is no potential UK tax advantage in this period, so no transfer pricing adjustment is appropriate, however, under s446 no transitional credits need to be brought into account for tax as these amounts do not exceed the amount of debits that have previously been disallowed under the transfer pricing rules. A similar analysis applies for years through to 2014.

B Ltd obtains tax relief of £30,000 for interest paid over the five year term of the debt.

CFM34050 - Loan relationships: group continuity: notional carrying value

Add the following text:

Interaction with New UK GAAP, FRS 26 under Old UK GAAP and IFRS

Under New UK GAAP, FRS 26 under Old UK GAAP and IFRS, companies will measure financial instruments on initial recognition at either present value (Section 11 of FRS 102) or fair value (Section 12 of FRS 102, FRS 26 under Old UK GAAP and IFRS).

Consequently, when applying the group continuity rule under CTA09/340 (which specifies that a transfer between group companies is treated as taking place at notional carrying value (NCV)) it will be necessary to make adjustments in the tax computations of the transferor and transferee. In particular, the transferee company will need to adjust its tax computation on the basis that the 'cost' of acquiring the loan was the amount of the NCV and, accordingly, that it measures the loan on initial recognition at that amount. The actual consideration paid and the actual present value / fair value of the loan on initial recognition are therefore ignored for tax purposes. This is necessary to give effect to the statutory purpose of the deeming in CTA09/340 and give continuity of treatment of the loan. In particular, the transferee company measures the loan on acquisition at the same amount as in the accounts of the transferor company immediately before disposal.

CFM35190 Connected companies: Interest-free loans and other non-market loans

Background

Under IFRS or New UK GAAP, companies are typically required to measure debt instruments at fair value or present value on initial recognition. The fair value or present value on initial recognition will normally, but not always, be equal to the transaction price. However, in cases where the loan is not entered into on arms' length terms then this is likely to lead to an accounting difference being booked on inception.

A particular issue arises in the context of interest-free loans where the debt is not immediately repayable on demand. In such cases the fair value / present value on inception could be less than the amount actually lent. Similar issues can also arise with other loans that are entered into on non-market terms.

This page of guidance looks to explain how this particular accounting issue should be treated for corporation tax purposes in the context of loans made between connected companies.

Tax treatment under section 349

Where the debt is between connected companies, both companies are required under section 349 CTA 2009 to apply an amortised cost basis of accounting. The meaning of amortised cost basis of accounting is specified in subsection 313(4) as:

> "… a basis of accounting under which an asset or liability representing the loan relationship is shown in the company's accounts *at cost* adjusted for cumulative amortisation and any impairment, repayment or release." (emphasis added)

This is similar to the definition of amortised cost under IFRS and New UK GAAP. The key difference is that it requires initial recognition at 'cost' rather than at 'fair value' or 'present value' (if different). In other words, this is aligned with the accounting under Old UK GAAP where FRS 26 has not been adopted.

What constitutes 'cost' will be a question of fact to be ascertained in the particular circumstances. In the straight forward case where a company simply borrows money, the 'cost' is likely to be the amount of cash actually lent. In more complicated situations, for example where loans are made for non-monetary consideration or as part of a series of linked transactions, what constitutes the 'cost' will need to be assessed based on careful consideration of all the facts.

In most cases loans will be advanced on arm's length terms and the 'cost' will be the same as the amount recognised on initial recognition. However, where there is a difference between the 'cost' of a loan and the fair value of the instrument on initial recognition (as will be the case with an interest-free loan) then the company will need to make computational adjustments to reflect the 'cost' of the loan.

See the example at CFM35192.

CFM35192: Connected companies: interest-free loans and other non-market loans: example

Example: transition to New UK GAAP

In 2010, an overseas parent (company P) lends £100m to its UK subsidiary (company S) on interest free terms with the debt repayable in ten years' time. Under Old UK GAAP (where FRS 26 is not applied) the companies simply hold the loan at its original transaction price of £100m. £100m represents the 'cost' of the loan.

In 2015 company S adopts New UK GAAP. As a result, for accounting purposes the carrying value of the loan is restated to be £80m on the basis that the loan should have been measured on initial recognition at its fair value / present value at that time. The loan will then be accreted back up to £100m on company S's balance sheet over the term of the instrument, with corresponding amounts recognised in the income statement as a loss.

However, company P and company S are connected companies, and so for tax purposes company S is required by CTA09/S349 to apply an amortised cost basis of accounting as specified by CTA09/313(4). Company S will continue, for tax purposes, to treat the loan as being measured at £100m. As a result, company S will not bring any amounts into account in respect of the loan relationship. No transitional amounts should be brought into account under the loan relationship provisions on adoption of New UK GAAP, and no amounts should be brought into account in respect of the accretion shown in the income statement.

A similar analysis would apply if company P were UK resident. However, it is likely that company P would need to impute interest under the transfer pricing rules. In this case company S may also be entitled to claim a compensating adjustment.

If the parties to the loan were not connected companies (so that section CTA09/S349 was not in point) then for tax purposes the credit of £20m recognised by company S on restatement would be brought into account on transition (typically spread over 10 years under the COAP Regulations). Subsequently the debits totalling £20m accreted over the life of the loan would be brought into account as they arose. However the application of other tax rules would need to be considered. In particular, the assumption of the arm's length provision in place of the actual provision under the transfer pricing rules would affect the accounting and tax treatment.

Further guidance

For further guidance on the corporation tax treatment of interest free loans and other loans on non-market terms see CFM33172 onwards.
