Corporation Tax: anti-avoidance rule to prevent loss refreshing

Technical note

18 March 2015

Contents Page

Foreword		3
Chapter 1	Overview	4
Chapter 2	Technical background	6
Chapter 3	Examples	9

Foreword

On 18 March 2015 the Chancellor of the Exchequer announced that the Government will introduce legislation in the Finance Bill 2015 to restrict the ability of companies to use tax-motivated arrangements to convert their old carried-forward reliefs into new reliefs that can be used more flexibility. Where the rule applies, companies will be prevented from using the carried-forward reliefs to reduce taxable profits that arise from the arrangements.

The rule will apply to carried-forward:

- trading losses;
- non-trading loan relationship deficits; and
- management expenses.

The restriction will take effect from 18 March 2015 and will only apply to profits arising on or after this date.

This document provides some technical details on the circumstances and manner in which the proposed legislation will operate.

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Chapter 1 – Overview

Scope of the rule

1. The rule will apply to all companies in charge to UK corporation tax.

2. The rule will apply to arrangements entered at any time, but the effect of the rules applies only to use of carried-forward relief against profits arising on or after 18 March 2015.

Loss refreshing arrangements

3. Situations can arise where a company finds its carried-forward relief of limited use because of its anticipated future profitability. There may be other connected companies that wish to access the carried-forward reliefs to reduce their profits.

4. Some companies will enter arrangements to access those losses by shifting profits around the group, or changing the timing of receipts, or similar. This may involve as simple an arrangement as shifting a profitable trade or income-producing asset into the company with carried-forward relief.

5. Some arrangements go further, and ensure that they also create a new in-year relief somewhere in the group where this would be of use, effectively turning the carried-forward loss into a new and more versatile in-year relief; 'refreshing' the loss.

6. The new measure will apply only to the latter type of tax arrangement and only then when it is reasonable to assume that the value of the tax advantage will exceed any other economic benefits referable to the arrangements.

Overview of the conditions

7. The rule will apply where all of the following conditions are met:

    - Condition A: Profits arise to a company as a consequence of arrangements against which relevant carried-forward reliefs could be set;
    - Condition B: New deductions arise to the company or a connected company as a consequence of the arrangements;
    - Condition C: The main purpose, or one of the main purposes, of the arrangements is to secure a corporation tax advantage involving the additional profits, the use of carried-forward relief against those profits, and the new deductions. The corporation tax advantage is assessed by reference to the position of the company itself, or, if there are connected companies, by reference to the position of the companies taken together ; and
    - Condition D: When the arrangements are entered into the value of the anticipated tax advantage is more than the anticipated value of any

other economic benefits to the arrangements. Again, the position is assessed by reference to the economic benefits accruing to the company and any connected companies taken together.

8. The rules will not apply where the targeted anti-avoidance rule in section 269CK of CTA 2010 applies (this was section 269M of CTA 2010 in the draft Part 7A released on 3 December 2014). This will only be relevant in the case of 'banking companies', as defined in Part 7A (broadly: banks and building societies).

Effect where the rule applies

9. Where all of the conditions are met, the company will not be able to use relevant carried-forward reliefs against the amount of profit arising from the arrangement.

10. Other reliefs (including the new relief meeting condition B) may still be available against the arrangement profits, within the normal rules.

Commencement

11. The rule applies to arrangements entered into at any time.

12. The rule is effective for accounting periods beginning on or after 18 March 2015, with transitional rules for accounting periods straddling that date.

13. Where a company's accounting period straddles 18 March 2015, two notional accounting periods are created. One ending 17 March 2015 and calculated on the existing basis, with no restriction on the use of carried-forward reliefs, and one commencing 18 March 2015 and restricting use where the rule applies.

14. The proportion of profits is apportioned on a time basis, unless such an apportionment would be unjust or unreasonable.

Chapter 2 – Technical background

Carried-forward reliefs

15. The UK's tax system allows reliefs that are not used in the current or previous year to be carried forward indefinitely and used against profits as they arise.

16. Such reliefs are either automatically set against income of the same type in the calculation of total profits, or allowed as a relief against total profits automatically or by means of a claim (section 4 of Corporation Tax Act 2010 (CTA 2010)).

17. The 'relevant carried-forward reliefs' for the purposes of this rule are:

    - trading losses carried forward under section 45 of the CTA 2010;
    - non-trading loan relationship deficits carried forward under section 457 of Corporation Tax Act 2009 (CTA 2009); and
    - management expenses carried forward under section 1223(2) of CTA 2009.

18. Management expenses includes carried-forward qualifying charitable donations made for the purposes of an investment business and unused losses of a ceased UK property business (section 63 CTA 2010).

Use of carried forward reliefs

19. Carried-forward trading losses can only be given as relief against profits of the same trade. Relief is automatic and given in calculating the total profits of the company (in subsection 4(3) of CTA 2010).

20. Carried-forward non-trading deficits can only be given as relief against non-trading profits. Relief is automatic and given in calculating the total profits of the company (also in subsection 4(3) of CTA 2010), unless the company makes a claim under section 458 of CTA 2009 to carry part or all of the deficit forward to future accounting periods.

21. Carried forward management expenses are treated as management expenses of the year and relief is given automatically against total profits (in subsection 4(2) of CTA 2010). Management expenses are expressly the first relief to be given against total profits (subsection 1219(1A) of CTA 2009).

22. Section 99 of CTA 2010 lists the reliefs that can be surrendered as group relief, which includes trading losses, non-trading loan relationship deficits, and management expenses.

23. Section 100 defines trading losses for this purpose as a loss made in the surrender period. Section 103(2) excludes management expenses that have been carried forward from being eligible for surrender. Subsection 457(3) of

CTA 2009 is prescriptive in how a carried forward non-trading deficit on loan relationship can be used, and does not allow surrender as group relief.

24. Hence none of the relevant carried-forward reliefs are available as group relief.

Use of relief in-year

25. Conversely:

    - A trading loss can be claimed against total profits (section 37 CTA 2010) or surrendered as group relief;
    - A non-trading deficit on loan relationship can be claimed against total profits (section 459 CTA 2009) or surrendered as group relief; and
    - Management expenses, although unchanged as side-ways relief, are available for surrender as group relief to the extent that they and other relevant reliefs exceed the company's profit-related threshold (section 105 CTA 2010).

26. Hence there is significantly more versatility for these reliefs in the period they arise.

Loss refreshing

27. The arrangements within the scope of this measure are those that seek to turn any of the relevant carried-forward reliefs into in-year deductions.

28. A deduction is anything that can reduce the taxable total profits of the company. This may be by reducing a profit, increasing a loss, or relieving a profit.

29. The deduction must be one that is produced in connection with the tax arrangement.

Conditions for the rule to apply

30. The arrangements within the scope of the rule display some common characteristics. That is, in each case:

    - The arrangements create new profits to accelerate the use of brought forward losses;
    - The arrangements create new in-year losses or deductions that will reduce the taxable income of the group;
    - A main purpose of the arrangements is to achieve that outcome; and
    - The anticipated tax advantage is more than the anticipated value of any other economic benefits to the arrangements.

31. These are reflected in the first four conditions in section 730G, which are outlined in paragraph 7 above.

32. The rule will apply provided that it can be established that certain steps in the arrangement were designed to secure the new deduction and creation of new income that would be covered by brought forward losses. This will be a question of fact, and assessed both by a motive test looking at the purposes of the arrangement (in condition C) and a reasonable-to-assume test based on what a reasonable view of the anticipated outcome of the arrangements would be (in condition D).

Chapter 3 – Examples

Overview of examples

33. These examples use a simplified analysis and ignore the effect of a number of other statutory provisions which may apply to the arrangements.

34. They are for illustrative purposes to demonstrate how the TAAR could apply to certain fact patterns.

35. HMRC will continue to apply the relevant legislation to these schemes on a case-by-case basis.

Arrangement 1: Intra-group and other hedging arrangements

Facts and background

36. D Group uses intra-group derivatives to hedge. D4 has substantial amounts of non-trading loan relationship deficits brought forward.

37. D1 has an external fixed rate loan liability of £1bn. The loan is a fixed-term five year loan with several years still to run.

38. D2 holds an interest rate swap with a third party, hedging the fair value risk in respect of D1's loan. D2 receives fixed, and pays floating, interest on a notional principal of £1bn.

39. The swap and loan are linked via a third company in the group, D3, which has entered into back-to-back derivative positions with D1 and D2.

40. From D3's perspective one of the swaps is in-the-money while the other is out-of- the-money.

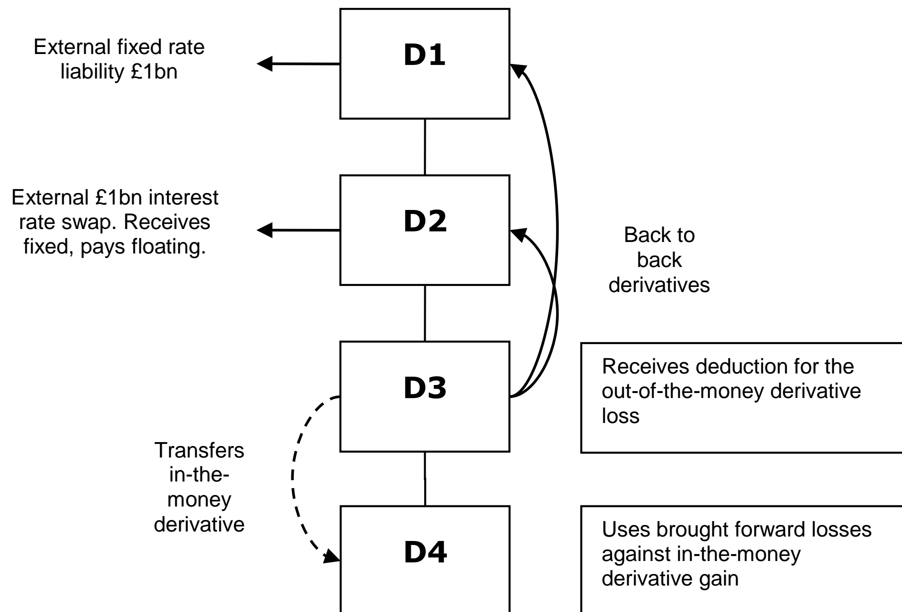
41. The Group wishes to stay hedged but also sees the opportunity to use its derivatives to convert its brought forward losses into current year ones.

42. To achieve this, D3 transfers the in-the-money derivative to company D4. D4 then realises the profit, which is covered by losses brought-forward.

43. D3 keeps the out-of-the-money derivative and triggers recognition of the loss on it, again by realising it, thereby giving rise to a versatile in-year deduction.

44. The group then enters into a new hedging arrangement on market terms to ensure that the external loan continues to be hedged.

45. The group has created a new versatile in-year deduction; the corresponding income is covered by brought forward losses.



Analysis - the rule will apply to this arrangement

46. In applying the TAAR, it is necessary to identify the relevant tax arrangement. This is the arrangement which consists in the transfer of the in-the-money swap to D4 followed by the realisation events that result in a profit for D4 and a loss for D3 (which would not have arisen absent the arrangements). It also includes the entering into of the new hedging arrangement immediately; demonstrating that closing down the swaps in this period was intended to create the tax advantage.

47. At group level this tax arrangement was anticipated to produce no economic benefit beyond the tax one. It is clear that a main purpose of the arrangement is to secure a corporation tax advantage, and so the TAAR will apply.

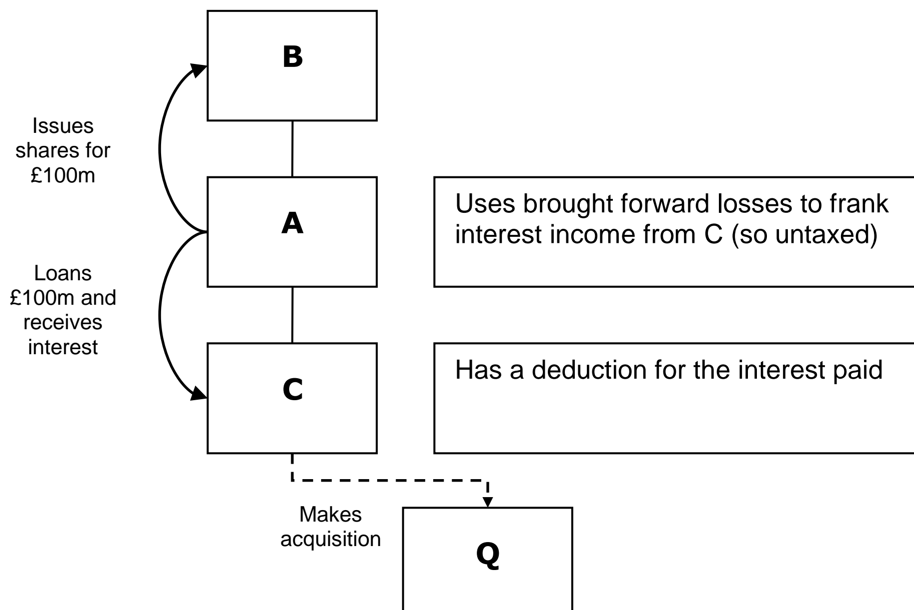
Arrangement 2: Intra-group loan and share issue

Facts and background

48. Company A, part of ABC group, has substantial amounts of non-trading loan relationship deficits brought-forward. ABC group wants to acquire shares in a third party (Company Q) as part of a commercial acquisition by the group.

49. Company A obtains equity finance from its immediate parent Company B by issuing shares to B for £100m. A lends the money to its subsidiary C, which then uses the money to purchase Company Q.

50. C pays interest on the loan to Company A, which is covered by brought forward losses. C obtains a new tax deduction.



Analysis - the rule will not apply

51. The relevant arrangement is the series of transactions consisting of the intragroup financing arrangements and the acquisition of Q by ABC Group. The main economic driver of that arrangement – and its largest anticipated benefit – is the opportunity to generate additional profits. As a result the TAAR will not apply.

Arrangement 3: Funding structure and changes to the funding structure

Facts and background

52. Company L has existing intra-group borrowing that it entered for commercial reasons. The existing funding may be interest bearing or interest free; though this could affect the analysis, the difference is ignored for the sake of simplifying the example.

53. L also has a substantial non-trading deficit brought forward and has no realistic prospect of using it in the near future.

54. The group changes the funding structure to accelerate the recognition of non-trading credits in L so as to use up the brought forward deficit and create a new deficit that can be used more flexibly. This is achieved as follows:

- The existing loan is replaced by another loan with a fellow group member which is interest free. In all other respects the terms of the loan is the same as the original loan.
- Under generally accepted accounting practice, the loan is recognised at a discounted value. For example, if the loan has a face value of £100m, it will be recognised as a loan of £95m being the present value of the obligation to repay £100m in two years' time. The loan then accretes back to £100m over the term of the instrument.

- It is claimed the excess on inception of £5m (cash received £100m, value of debt recognised £95m) would be recognised as an upfront taxable profit, covered by brought forward losses.
- It is also claimed that accretion of the loan back to £100m gives rise to a tax deduction of £5m over the term of the instrument. This loss of £5m is then surrendered to other members of the group. Thus, a brought forward loss is converted into fresh losses over the term of the loan instrument.

Analysis – the TAAR will apply

55. Overall at group level there is no economic benefit from this planning. The arrangement is wholly designed to use up old losses and create new ones. Accordingly, the TAAR will apply.

Arrangement 4: Transfer of a profitable income stream

Facts and background

56. Company F has substantial trading losses carried-forward, and little prospect of making profits in the future.
57. Company S, a company that has been in the same group as F for some time, has a profitable trade.
58. Company S transfers its trade to F (Part 14 of CTA 2010 is assumed not to apply), and F is liquidated.

Analysis – the TAAR will not apply

59. The arrangement has not generated a new deduction, so the TAAR will not apply.