CLAUSE 37 AND SCHEDULE 6: ACCOUNTING PRACTICE AND RELATED MATTERS

SUMMARY

1. Schedule 6 amends the legislation on the use of International Accounting Standards (IAS) for tax purposes enacted in Finance Act 2005. In particular, it amends the provision which ensures that companies do not get a tax advantage where a company connected with the borrower buys a bad debt from a lender at a discount. The rule currently goes further than was intended. In addition there are a number of other minor changes to the FA 2005 legislation.

DETAILS OF THE CLAUSE

2. Clause 37 gives effect to Schedule 6.

DETAILS OF THE SCHEDULE

3. Paragraph 1(1) ensures, by amending paragraph 4 of Schedule 22 FA 2002, that there is no deferral in taxing the uplift arising from the prior period adjustment for companies with a period of account lasting more than one year. Section 81(2) FA 2005 amended paragraph 4(3) of Schedule 22, but that amendment can only apply for periods beginning on or after 1 January 2005 and ending before 6 April. It did not take into account the Income Tax (Trading & Other Income Act) 2005 (ITTOIA) changes which substituted a new paragraph 4 Schedule 22 without any sub-paragraphs. This paragraph therefore makes the necessary change in "paragraph 4", and not in paragraph 4(3).

4. Paragraph 1(2) provides that the change has effect for periods of account beginning on or after 1 January 2005 where an accounting period ends after 5 April 2005– the first such period from which ITTOIA is effective.

5. Paragraph 2(1) expands the meaning of "relevant change of accounting approach" in section 227 of ITTOIA. It substitutes a new subsection (4) to include a change from using UK Generally Accepted Accounting Practice (GAAP) to using IAS, whether or not a prior period adjustment is disclosed. UK GAAP and IAS are defined in section 50 Finance Act 2004.

Such a substitution has already been made for companies by section 81(1) FA 2005, but this paragraph is required to make the same change for partnerships and other entities that may use IAS.

6. Paragraph 2(2) provides that the change has effect for periods of account beginning on or after 1 January 2005 from the tax year 2005-06 – the first such year for which ITTOIA is effective.

7. Paragraph 8 of Schedule 4 FA 2005 introduced a new definition of 'statutory insolvency arrangement' for the purposes of corporation tax (CT), included in section 834(1) ICTA 1988. Paragraph 3(1) extends the definition at 834(1)(c) to partnerships and other entities that may use IAS by substituting a new section 259 ITTOIA.

8. Paragraph 3(2) provides that the change has effect for periods of account beginning on or after 1 January 2005 from the tax year 2005-06 – the first such year for which ITTOIA is effective.

9. Paragraph 4(1) to (6) makes a number of additional minor amendments to changes brought in by paragraphs 6, 31 and 35 Schedule 4 FA 2005, and to earlier legislation at subparagraphs (4) and (5). They are treated as always having had effect.

10. Paragraph 5(1) substitutes an amended version of paragraph 4A Schedule 9 FA 1996 for that originally enacted by paragraph 10 Schedule 4 FA 2005. New paragraph 4A(1) provides that the rule applies in two circumstances.

11. The first of these, set out in new paragraph 4A(2) is where a company acquires a debt from an unconnected creditor, and immediately after the acquisition is connected with the debtor company. This may be because the company acquiring the debt was already connected with the debtor company, or because it acquired shares in the debtor company at the same time as the debt.

12. The provision does not apply where the company acquiring the debt ("the new creditor") is connected with the old creditor in the period of account during which the acquisition occurs. This is a change from the earlier version of paragraph 4A. It ensures that the provision does not impose a tax charge on the debtor company where debt is transferred between companies in a group, as may occur in a commercial restructuring.

13. The final condition is that the new creditor pays less for the debt than its carrying value in the books of the debtor company at the time of the acquisition. This condition will be fulfilled where the debt is impaired – the creditor does not expect to be repaid its full amount. In determining the

carrying value of a debt asset or liability, no notice is taken of accrued amounts, amounts paid or received in advance, or impairment losses – new paragraph 4A(10).

14. This again corrects a defect in the original provision. It ensures that paragraph 4A does not apply in a case where the new creditor pays less than the face value of the debt solely because the debt was originally issued at a discount. And it makes it clear that in determining the carrying value of a debt, accrued interest is left out of account.

15. New paragraph 4A(3) sets out an exception to this first circumstance – where the new creditor acquires the debt in an arm's length transaction from an unconnected creditor, and there was no connection between it and the debtor company at any time in a period beginning 4 years before the transaction, and ending 12 months before the date of the transaction. This remains unchanged from the earlier version.

16. New paragraph 4A(4) gives the second circumstance. It is where the creditor is originally unconnected with the debtor, but becomes connected – for example, if the creditor acquires a majority shareholding in the debtor.

17. Furthermore the creditor company – had it drawn up a balance sheet immediately before the companies became connected – must have had to adjust the carrying value of the debt for impairment. This condition is a change from that in the original enactment. It makes it clear that only diminutions in value of the debt as a result of impairment are taken into account, not for example a decrease in value of a fixed rate debt as a result of interest rate rises.

18. New paragraph 4A(5) provides that, where either of the two circumstances apply, there is deemed to be a release of the debt by the debtor company, which results in a taxable credit for the debtor. In the first case, the amount of the credit is the difference between carrying value of the debt in the debtor's books and the amount paid by the new creditor – new paragraph 4A(6). In the second case, a credit of the amount of the impairment adjustment arises when the creditor company becomes connected with the debtor – new paragraph 4A (7).

19. New paragraph 4A(8) avoids doubt by adding a definition of connection. This is taken from section 87 FA 1996 – two companies are connected if one has control over the other, or both companies are under common control, where "control" takes its meaning from section 87A FA 1996.

20. New paragraph 4A(9) ensures that section 87(4) and section 88 FA 1996 also apply for the purposes of paragraph 4A. The first of these provisions

stops two companies being treated as connected because they are both under control of the Crown or a government department. The second provides an exemption for companies dealing in securities, who may acquire connected party debt in the normal course of trade.

21. Paragraph 5(2) provides that the amended version of paragraph 4A Schedule 9 FA 1996 has effect from 16 March 2005 – Budget Day.

22. Paragraph 6(1) adds a new sub-paragraph (4BA) to paragraph 19A Schedule 9 FA 1996. Paragraph 19A ensures that when, as a result of a change in accounting policy, there is a difference between the carrying value of a loan relationship asset or liability between the end of one accounting period and the beginning of the next, that difference is brought into account as a debit or credit. Paragraph 31 Schedule 4 FA 2005 introduced two new sub-paragraphs, (4A) and (4B), that set out what is meant by carrying value – in particular, it is adjusted where the loan relationships legislation and other provisions make tax adjustments. New sub-paragraph (4BA) further provides that in determining the carrying value of an asset at the end of the earlier accounting period, no account is taken of a debit previously disallowed because it was not within paragraph 5(1) Schedule 9 FA 1996 (for a loan relationship) or section 74(1)(j) Taxes Act 1988 (for a trade debt) – perhaps because the provision was computed on a formulaic basis that was not acceptable under that legislation. The effect is to give the company relief, as a transitional debit, for the previously disallowed provision.

23. Paragraph 6(2) sets the commencement date for the amendment – periods of account beginning on or after 1 January 2005.

24. Paragraph 7 replaces sub-paragraphs (3) and (4) of paragraph 28 Schedule 4 FA 2005 (which are repealed) with a new measure serving the same purpose.. . Section 94A FA 1996 provides that where, under FRS 26 or IAS 39, a company with a debt asset or liability (such as a convertible security) that contains embedded derivative accounts separately for the host debt and the derivative, the two components are treated separately for tax purposes. Paragraph 28 Schedule 4 FA 2005 introduced, in sub-paragraphs (3) and (4), an election for companies not using FRS 26 or IAS 39 to nevertheless adopt the section 94A tax treatment.

25. Paragraph 7(1) provides that where a company in a period of account beginning on or after 1 January 2005 is not permitted to adopt bifurcation treatment in its accounts for loan relationship assets containing embedded derivatives ("relevant assets") because it still uses "old UK GAAP", it can elect for section 94A(1) to apply. ("Old UK GAAP" and "new UK GAAP" are defined at paragraph 7(7) to mean generally accepted accounting

practice as it applied respectively to periods of account beginning before 1 January 2005, and periods beginning on or after that date.) The revised provision clarifies that, as a result of such an election, the loan relationships legislation will apply to a deemed host contract, and the derivative contracts legislation to a deemed derivative.

26. Paragraph 7(2) extends the deadline for such an election from 31 July 2005 to 31 December 2005. Paragraph 7(3) allows a company that does not hold relevant assets at the beginning of its first period of account beginning or after 1 January 2005, but subsequently acquires such assets, to make a later election – but it must elect within 90 days of acquiring its first relevant asset. It also permits a later election in the rare event of the company holding relevant assets but not having a period of account beginning in 2005. The company must elect within 90 days of its first period of account beginning in 2006.

27. Paragraph 7(4) provides that the election applies to all of the company's relevant assets. Paragraph 7(5) specifies when the election has effect. An election generally has effect from the first day of a company's first period of account beginning on or after 1 January 2005. For example, if a company prepares accounts for periods 1 January 2005 to 30 June 2005, and 1 July 2005 to 30 June 2006, an election made in December 2005 will have effect from 1 January 2005. If, however, it makes an election after 31 December 2005 because of a first-time acquisition of relevant assets, the election has effect from the beginning of the period of account in which the first relevant asset is acquired.

28. Paragraph 7(6) applies paragraph 19A Schedule 9 FA 1996 and the equivalent derivative contracts provision in paragraph 50A Schedule 26 FA 1996. These provisions pick up, as credits or debits, any changes in value of a company's loan relationships or derivative contracts as a result of a change in accounting policy. The effect of paragraph 7(6) is to ensure that no amounts fall out of account when the tax treatment of a relevant asset changes as a result of an election, even though there has been no actual change in accounting policy.

29. Paragraph 7(8) makes it clear that any election already made under paragraph 28(3) Schedule 4 FA 2005 will continue to have effect.

30. Paragraph 8 inserts a new subsection (8B) into section 116 TCGA 1992. Its effect is to disapply section 116(8A) where a convertible security is converted into shares. Where a convertible security that is a qualifying corporate bond is converted into shares, section 116(8A) provides that for the purposes of loan relationships the event is treated as a disposal at market value. But where the security is treated under section 94A(1) as

both a loan relationship and a derivative contract, application of section 116(8A) would give anomalous results. The paragraph has effect for conversions taking place after 26 May 2005.

31. Paragraph 9(1) provides for the repeal of section 84A FA 1996, which, while affirming that exchange gains and losses on loan relationships are chargeable under Part 4 Chapter 2 FA 1996, also provides for such exchange differences to be disregarded in certain circumstances. It also provides for the repeal of paragraph 16 Schedule 26 FA 2002, the equivalent derivative contracts measure.

32. Paragraphs 9(2) and (3) provide that the repeals will only take effect from a day appointed by Treasury order, and further provides that the order may contain appropriate savings and transitional provisions. A number of concerns have been raised in consultations about the interaction between parts of section 84A and paragraph 16, and the Disregard Regulations (Statutory Instrument 2004 No 3256), which also provide for certain profits or losses on currency contracts to be disregarded. Work is in progress to resolve these technical issues. It is possible that the solution may lie in repeal of section 84A FA 1996 and paragraph 16 Schedule 26 FA 2002, as well as the laying of further secondary legislation: paragraph 9 allows such a solution to be implemented.

33. Paragraph 10 replaces section 103(1AA) FA 1996 – introduced by paragraph 29 Schedule 4 FA 2005 – with an amended version. This provides a regulation-making power to specify how exchange gains and losses on loan relationships are to be computed where the company uses fair value accounting. Such regulations may apply with a limited degree of retrospection – so that, for example, regulations made in 2005 could apply from 1 January 2005, but not earlier.

34. Paragraph 11 is a precisely analogous provision for derivative contracts, replacing paragraph 54(2A) Schedule 26 FA 2002 by a regulation-making power.

BACKGROUND NOTES

35. In 2002 the European Union approved a Regulation (having direct effect in member states) that requires the consolidated (group) accounts of listed (on a stock exchange) companies to be drawn up using International Accounting Standards (IAS) from 2005. These consolidated accounts are not used for tax purposes. In 2003 the DTI announced that the UK would take up an option in the Regulation to permit, but not require, all UK companies to use IAS to draw up their accounts, also from 2005.

36. Finance Act 2004 introduced legislation which allowed accounts, prepared by individual companies, using IAS to be used for tax purposes. It also contained provisions which maintained the tax position under UK Generally Accepted Accounting Practice (GAAP) where the treatment differed significantly under IAS.

37. IAS differ from UK GAAP in a number of specific areas. The main area where there is a difference is in the field of financial instruments where IAS 39 applies. There is no UK Standard dealing with the holder of financial instruments.

38. Finance Act 2005 continued the work begun in Finance Act 2004. Schedule 4 in particular covered many of the changes required by IAS 39. Consultations are continuing on a number of technical areas. These consultations have brought to light a number of problems with the detailed workings of the Finance Act 2005 provisions, which are addressed in this schedule. A Working Group on the tax implications of IAS 39, composed of representatives of the professions, business and HM Revenue and Customs continues to meet. It is concentrating on two areas that have caused particular difficulty: the hedging of foreign currency risk, and the treatment of convertible and asset-linked securities.

EXPLANATORY NOTE

CLAUSE 38: CHARGES ON INCOME FOR THE PURPOSES OF CORPORATION TAX

SUMMARY

1. Clause 38 removes annuities and other annual payments from the scope of "charges on income" for the purposes of corporation tax. Any such payments incurred for a business purpose will fall to be deducted as expenses of management. Charitable payments continue to be treated as charges on income.

DETAILS OF THE CLAUSE

2. Subsections (1) and (2) provide for the amendments of, and amend, section 338A Income and Corporation Taxes Act 1988 (ICTA) by removing subsection (2)(a). Thus annuities and annual payments no longer count as charges on income in any case where they are not deductible in computing the profits of a trade. The only types of payment that remain deductible as charges on income are charitable donations (Gift Aid) and gifts of shares etc to charity within section 587B ICTA. Section 338A(4) (insurance companies – exceptions from treating annuities as chares on income) is also repealed as unnecessary.

3. Subsection (3) amends section 125 ICTA. That section denies relief for annuities and other annual payments not made for a taxable consideration. The amendment, taken with the repeals, has the effect that for corporation tax purposes section 125 has effect only where the question is whether an annual payment is deductible in computing income such as the profits of a trade or the profits of a company with investment business.

4. Subsection (4) removes a reference to charges on income from section 434A ICTA (losses of life assurance business). This reference became redundant from 1 April 2004 as a result of the amendments made to section 88 Finance Act (FA) 1989 by paragraph 45 of the Schedule to the Finance Act 2004, Sections 38 to 40 and 45 and Schedule 6 (Consequential Amendment of Enactments) Order 2004 (SI 2004/2310). Subsection (6) gives the commencement rule for this subsection – accounting periods beginning on or after 1 April 2004.

5. Subsection (5) amends the sidenote to section 494 ICTA (deductions from ring fenced North Sea oil profits) as a result of the repeals in the section made by Schedule 21 (repeals). As the section no longer refers to charges on income the sidenote now says "loan relationships etc." to reflect its subject matter.

6. Subsection (7) gives the commencement date for the rest of the section – in relation to payments made on or after 16 March 2005 (Budget Day).

7. Subsections (8) and (9) gives one of the commencement rules. They apply where an accounting period pf a company straddles Budget Day, and a payment is made before Budget Day deductible as a charge on income. Because charges are deductible when paid and management expenses and expenses payable under section 76 on the basis of accounting recognition, subsection (9) provides that no deduction is to be given under section 75 or 76 for any amount already relieved as a charge on income.

8. Subsections (10) to (12) deal with the converse case, where a payment of an annuity or annual payment is made on or after Budget Day (subsection (10)) and the payment would have been deducted under section 75 or 76 (as a result of being recognised in the company's accounts before Budget Day) except for the rule in section 337A(1)(b) which denies relief in any other way for charges on income (subsection (11)). In this case the amount may be deducted under section 75 or 76 for the accounting period in which the payment is made. This rule will apply to payments made after they are accrued in a company's accounts.

9. Subsection (13) defines the commencement date – a term used in subsections (7) and (8) - as being 16 March 2005.

10. In addition Division 6 of Part 2 of Schedule 11 repeals a number of other redundant references to charges on income in:

    - sections 338B, 402, 487, 494, 494A and Schedule 28AA ICTA;
    - section 102 FA 1989;
    - sections 171A and 179A Taxation of Chargeable Gains Act 1992;
    - Schedule 29 FA 2002.

BACKGROUND NOTES

11. Before FA 1996 the list of charges on income that could be set off against profits for the purposes of corporation tax was extensive. Section 338 ICTA (as it then stood) provided that "charges on income" meant for the purposes of corporation tax –

   - any yearly interest (whether charged to revenue or capital);
   - any other interest (whether charged to revenue or capital) payable in the United Kingdom on an advance from a bank;
   - annuity or other annual payment;
   - royalty or other sum paid in respect of the user of a patent;
   - rent, royalty or other payment which, by section 119 or 120 ICTA, was declared to be subject to deduction of income tax as if it were a royalty or other sum paid in respect of the user of a patent;
   - payments which were qualifying donations (within the meaning of section 339 ICTA);
   - certain manufactured overseas dividends – Schedule 23A ICTA;
   - the income element of a deep discount security was treated for the purposes of CT as a charges on income – paragraph 5(2) Schedule 4 ICTA; or
   - a discount on a bill of exchange was treated for the purposes of CT as a charge on income – section 78 ICTA.

12. The most important by far of these categories of charge was yearly interest. Much bank interest would usually be deductible in computing profits so was less likely to be a charge. Annuities were important for life assurance companies but few others. Qualifying donations to charity were a substantial part of the scene.

13. FA 1996 and subsequent Finance Acts removed many of these including annual interest. What is left are –

- annuities and other annual payments (not paid by trading companies);
- qualifying donations within section 339 ICTA; and
- amounts falling with section 587B ICTA (gifts of assets to charity).

14. In the light of these changes the Government felt that the time had come, as part of Schedular reform, to abandon the concept of charges on income for corporation tax. Such a proposal was floated in the PBR Technical Note on CT Reform (2 December 2004). Responses to the consultation are still being considered. However, disclosures under Part 7 FA 2004 have necessitated early action.

15. Certain disclosures under Part 7 FA 2004 have shown that annual payments are being used in schemes to create an artificial deduction which is not matched by any taxable income. Elsewhere the Finance Bill amends section 125 ICTA. In its original form, it denied relief for annual payments where the consideration for them was not brought into account for tax at all. The amendment extended it to cases where the consideration was a dividend. This ensured that where a dividend carried a substantial amount of foreign tax exceeding the UK tax otherwise chargeable, section 125 would apply. This was on the basis that no UK tax payable because of double taxation relief is equivalent to not being charged at all.

16. It is clear that one of the great attractions of annual payments was that unlike most other deductions there is no “unallowable purpose” rule. Such a rule was introduced for manufactured overseas dividends and management expenses in FA 2004, so avoiders seem to be turning to the last remaining field where there is no serious barrier to unfettered relief.

17. So the Government is acting in advance of any decision on Corporation Tax Reform. But at this stage the concept of charges on income is being retained to deal with qualifying donations to charity and section 587B ICTA payments, pending the outcome of the consultation on the Technical Note on Corporation Tax Reform.

EXPLANATORY NOTE

CLAUSE 39 AND SCHEDULE 7: AVOIDANCE INVOLVING FINANCIAL ARRANGEMENTS

SUMMARY

1. Clause 39 and Schedule 7 close a number of loopholes and block a number of avoidance schemes disclosed under Part 7 Finance Act ("FA") 2004 and elsewhere. They all exploit legislation relating to financial products and arrangements of the types for which disclosure of schemes is required. The main categories of affected schemes are ones which:

- convert interest type income into a capital gain or an untaxed receipt;
- exploit a loophole in the loss-buying rules;
- involve capital redemption bonds and the creation of artificial losses;
- exploit the 15 year cut off in the rent factoring rules;
- attempt to claim a double deduction under both the manufactured interest rules and the accrued income scheme;
- exploit perceived weaknesses in the arm's length rule for loan relationships and the group continuity rules for them and for derivative contracts;
- use strips of corporate bonds to create discount which is not taxable under existing legislation, and strips of annuities and annual payments to exploit existing anti-avoidance legislation.

DETAILS OF THE CLAUSE

2. The clause introduces the Schedule

DETAILS OF THE SCHEDULE

Paragraph 1: Rent factoring

Detail

3. Paragraph 1 of the Schedule amends the legislation in Part 2 of Income and Corporation Taxes Act 1988 ("ICTA"), sections 43A to 43G, which are about "rent factoring": sub-paragraph (1) introduces the amendments to ICTA.

4. Paragraph 1(2) omits section 43C(1) which gives the 15 year limit for standard rent factoring schemes.

5. Paragraph 1(3) omits section 43E(1)(a) and (b), which limit the length of a caught lease granted at a premium to 15 years and require the length of the financial arrangement being reduced to be less than 15 years in cases where an interposed lease arrangement is used.

6. Paragraph 1(4) provides the main commencement rule – the paragraph applies to arrangements entered into on or after 16 March 2005.

7. Paragraph 1(5) to (7) qualify this in the case of interposed lease schemes. Where an arrangement involving an interposed lease was entered into between 20 March 2000 (when the rent factoring legislation was introduced) and 16 March 2005 which would have fallen within section 43D but for the 15 year rules in section 43E, any payments of an amount of principal in rent under a lease which relate to rental periods after Budget Day will not be deductible in computing profits in accordance with the provisions of Case I of Schedule D or as expenses within sections 75 or 76 ICTA.

8. Where a rental period straddles 16 March, the amount relating to the period from that day will not be deductible – paragraph 1(7).

9. Paragraph 1(8) defines an "amount of principal in rent" as so much of the rent payable under a lease as reduces the financial obligation for accounting purposes, and a "rental period" as a period in respect of which rent is paid.

Background

10. Sections 43A to 43G ICTA counter avoidance through what is known as rent factoring. In substance rent factoring schemes are equivalent to bank

loans but they aim to get a more advantageous tax result for the companies using them.

11. The schemes can have different mechanisms but generally follow the same fundamental approach. In the most common type of scheme, such as the one examined in the case *John Lewis Properties plc v CIR* 2003 [STC] 117, in exchange for a lump sum, in essence a loan, a company diverts future rents from property to a financier, usually a bank. The rents repay the capital element of the loan as well as paying the interest. By exchanging future income for a lump sum taxable only (if at all) under the rules in the Taxation of Chargeable Gains Act 1992 ("TCGA"), the borrower aims to get tax relief (by forgoing the rents no tax is paid on them) that would not otherwise be available for loan repayments.

12. Rent factoring can take a number of other forms. For instance a company rather than assigning rents, may grant the bank a lease on contrived terms, interposed above the lease of the property to the operating companies.

13. Section 43C(1) provides an exception from the rent factoring tax charge where the financial obligation in respect of the finance amount is to be reduced over a term exceeding 15 years.

14. Section 43E provides further exclusions from the charge where a lease is interposed. Under section 43E(1), the charge is disapplied when
    - the financial obligation is to be reduced over a term exceeding 15 years; or
    - the lease has a term not exceeding 15 years; or
    - these two terms are not significantly different.

15. Since the enactment of the legislation in 2000 schemes have been seen which exploit the 15 year rule, and some such schemes have been disclosed under the Disclosure rules in Part 7 FA 2004.

Paragraph 2: Section 730 ICTA 1988

Detail

16. Paragraph 2(1) provides that section 730 ICTA 1988 is amended.

17. Paragraph 2(2), (3), (7), (8) and (9) restricts the application of the section to distributions in respect of company shares and modernises the language. In particular it removes the non-application of any tax charge on the recipient of the actual distribution.

18. Paragraph 2(4) reflects changes made by the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA") and reverses the order of priority as between other charges on the sale of coupons and this section, so the other provisions have priority.

19. Paragraph 2(5) omits section 730(2A). That subsection provided that section 730 did not apply to affect the loan relationships code. But as section 730 is now being limited to distributions and shares, it cannot any more affect that code.

20. Paragraph 2(6) ensures that there is no double taxation on the sale of coupons.

21. Paragraph 2(10) replaces the existing section 730(7), which is a definition section, with a new one defining distribution and shares in modern terms.

22. Paragraph 2(11) omits the words in section 730(8) dealing with information powers in relation to interest.

23. Paragraph 2(12) changes the section heading to reflect the restricted application of the section.

24. Paragraph 2(13) provides that the changes apply to sales or transfers of income on or after 2 December 2004.

Background

25. Section 730 ICTA 1988 prevents avoidance of tax where a person sells or transfers the right to income from a security without selling or transferring the security itself. It reverses a court decision in the 1930s that the proceeds of sale of such income were not taxable.

26. Sale or transfer of the right to income without selling or transferring the underlying security is known in modern language as stripping of the security. There are special rules in the relevant discounted securities regime in Schedule 13 FA 1996 to tax strips of government securities (gilt strips).

27. Those rules have been extended in the Finance Bill to all interest bearing securities, and so there is no longer any need for section 730 to apply to such securities. The section is therefore being restricted to sales of income (i.e. distributions) in respect of company shares.

28. The changes apply to sales or transfers of income on or after 2 December 2004.

Paragraph 3: loss buying

Detail

29. Paragraph 3 closes a loophole in the loss buying legislation at sections 768 to 768E and Schedule 28A ICTA.

30. The main changes are made by paragraph 3(5) and (6). They provide a rule (inserting new paragraphs 9A and 10A into Schedule 28A ICTA) which prevents non-trading loan relationships deficits ("NTLRDs") from being carried forward from the deemed accounting period ending with a relevant change of ownership to the next accounting period when the company is under new ownership. Such a rule was missing from Schedule 28A, although there were rules disallowing similar carry forwards in all other cases of losses.

31. Paragraph 3(1) and (2) amend section 768B(10) and 768C(9) ICTA respectively so that they refer to NTLRDs as one of the types of loss which Schedule 28A operates on; and sub-paragraph (8) amends the title of Part 4 of Schedule 28A to refer to NTLRDs.

32. Paragraph 3(3) merely introduces the amendment to Schedule 28A, while paragraph 3(4) and (7) clarify that paragraphs 7(b) and 13(1)(ec) Schedule 28A do apply to NTLRDs.

33. Paragraph 3(9) gives the commencement rule – it applies to cases where the change of ownership that triggers section 768B or 768C is on or after 10 February 2005, when the closure of the loophole was announced.

Background

34. Sections 768 to 768E ICTA counter "loss-buying", where a person buys a company wholly or partly for its unused losses rather than solely for the inherent value of its trade, business or assets. The new owner usually introduces new activity into the company. Thus, but for sections 768 to 768E, the company would keep its entitlement to relief for losses brought forward. Section 768 applies where either:

    - within any period of 3 years there is both a change in the ownership of a company and a major change in the nature or conduct of a trade carried on by the company, and

    - there is a change in ownership of a company at a time when the scale of its trading activities has become small or negligible.

35. Where the conditions of section 768 are satisfied, all the company's unused trading losses as at the date of the change of ownership cannot be carried forward over the change of ownership.

36. Sections 768B to 768E provide rules very similar to those in section 768 so as to restrict the utilisation of amounts other than trading losses. Section 768B in particular applies to a company with investment business and to amounts within the loan relationships code. Schedule 28A ICTA sets out how accounting periods in which there is a change of ownership are treated as two separate periods, and how various amounts are apportioned between a pre-change of ownership period and a post-change period.

37. When the loan relationships code was enacted in FA 1996, amounts carried forward were called “debits” rather than deficits, and Schedule 28A dealt properly with such debits carried forward. In FA 1998 “debits” was changed to “deficits” with retrospective effect, but not all the appropriate amendments were made to Schedule 28A. As a result, there is no practical restriction on carrying forward non-trading loan relationships deficits.

Paragraph 4: Stripping annuities: section 775A ICTA 1988

Detail

38. Paragraph 4(1) inserts a new section 775A into ICTA.

39. New section 775A(1) provides the terms of the charge under the section. It applies to charge to tax any sale or transfer of the right to receive an annual payment (which includes an annuity) where the consideration for the sale or transfer is not already within a charge to tax.

40. New section 775A(2) provides that the charge is under the section in the case of income tax, and in the case of corporation tax is under Case III of Schedule D (see section 18(3A) ICTA).

41. New section 775A(3) determines on whom, when and on what amount the charge arises. The amount is the market value of that right transferred; the person chargeable is the transferor and the time is the chargeable period (accounting period (CT) or year of assessment or tax year (IT)) in which the transfer takes place.

42. New section 775A(4) sets out the exceptions. The section does not apply to:

- an annual payment under a life annuity as defined in section 657 ICTA or 473 ITTOIA (see new section 775A(7));
- pension income within Part 9 Income Tax (Earnings and Pensions) Act 2003 (see new section 775A(7)); or
- an annual payment to which section 347A ICTA or section 727 ITTOIA 2005 applies (annual payments by individuals that are not charges on income and not chargeable to income tax).

43. New section 774A(5) and (6) make it clear that the section applies to parts of payments, and that the transfer of all the rights under an annuity or agreement to receive an annual payment is within the scope of section 775A(1).

44. Paragraph 4(2) gives the commencement rule – it applies to sales or transfers on or after 16 March 2005.

Background

45. This paragraph is consequential on the restriction of section 730 ICTA to sales or transfers of distributions in respect of shares. That section previously covered sales of rights to interest and annuities.

46. It ensures that where a person sells or transfers the rights to some or all of the payments due under an annuity or other obligation to make annual payments, the market value of the rights disposed of is taxed as income. The measure does not apply to life annuities or pension annuities

Paragraph 5: see notes on paragraph 10

Paragraph 6:Manufactured interest & the accrued income scheme

Detail

47. Paragraph 6 clarifies existing anti-avoidance legislation concerning the income tax relief available for payments of manufactured interest.

48. Paragraph 6(1) provides that paragraph 3 Schedule 23A ICTA 1988 (manufactured interest) is amended.

49. Paragraph 6(2) amends paragraph 3(2A)(a) and (b) to ensure that;

- where the limit of relief for manufactured interest is given by reference to interest received which is chargeable to tax, the amount so chargeable takes into account any relief due under the accrued income scheme.

- where the limit of relief for manufactured interest is given by reference to an accrued income scheme charge, that limit is calculated after deducting any accrued income scheme reliefs.

50. Paragraph 6(3) makes an ITTOIA consequential amendment to the new wording in paragraph 3(2A)(b)

51. Paragraph 6(4) and (5) provides the commencement rule for paragraph 6(3) and 5(2) respectively. For paragraph 6(2) it is that the changes apply to relief in respect of payments of manufactured interest made on or after 16 March 2005. The paragraph 6(3) amendment has effect from 6 April 2005 when ITTOIA begins to apply.

Background

52. These paragraphs make changes to the rules that govern the limit for income tax purposes of relief for manufactured interest, to put it beyond doubt that that the rules interact properly with any reliefs or charges due under the Accrued Income Scheme (AIS).

53. Manufactured interest is a payment made under a contract or arrangement for the transfer of securities and which represents interest paid on that security. Such a payment is commonly made under standard repo or stock lending agreements used in the financial markets. Income Tax relief for manufactured interest is limited to the amount of taxable income that the manufacturer realises from the arrangement under which the liability to pay the manufactured interest arises. This rule was an anti-avoidance measure introduced in FA 2002.

54. The AIS is an anti-avoidance measure introduced in 1985 to prevent avoidance of tax by a process known as ‘bondwashing’. This is where a person sells a security just before interest is paid and buys it back shortly afterwards. The value of the interest is realised in the sale cum-interest. This has the effect of converting taxable interest into a more lightly taxed capital gain or into a tax nothing. The AIS works by taxing interest for a period in which a security is transferred on an accruals basis.

55. The avoidance disclosure rules have revealed schemes which seek to take advantage of the interaction between these two sets of rules, by structuring a transaction where manufactured interest is paid and there is an AIS relief due. It is claimed that the AIS relief does not restrict the amount of relief for manufactured interest, thereby resulting effectively in a double deduction for income tax purposes, creating a net relief which can be set against other income even though there is no economic loss.

56. These changes put it beyond doubt that the manufactured interest rules and the AIS interact as intended. They ensure that the limit of relief for manufactured interest is net of any AIS relief, or of the net amount of AIS charges and reliefs, thus restoring the tax neutrality for the transaction.

Paragraph 7: see notes on paragraph 12

Paragraph 8: see notes on paragraphs 21 & 25

Paragraphs 9 & 10: shares treated as loan relationships

Detail

57. Paragraph 10(1) to (6) inserts new sections 91A to 91G into Chapter 2 Part 4 FA 1996 (loan relationships) and gives the group of sections a new heading.

58. Paragraph 10(2) inserts a new section 91A into FA 1996.

59. New section 91A(1) sets out the case. It is where a company holds shares which—

- are subject to third party obligations (as to which see sections 91A(5) and (6) and paragraph 62 below)

and

- are an interest like investment (see section 91A(7) and (8) and paragraph 63 below)

60. Where the case applies, new section 91A(2) says that the share is treated as a creditor loan relationship for the purposes of Chapter 2 Part 4 FA 1996, and any distribution is not a distribution within section 209(2)(a) or (b) ICTA 1988 (and so is not exempt from corporation tax by virtue of section 208 ICTA).

61. For those purposes, a fair value method of accounting must be used for tax purposes (new section 91A(3)) and the rights under the outstanding obligations must be taken into account in arriving at the fair value of the share (new section 91A(9)). No debits are to be brought into account in respect of a transaction intended to make the share not an interest-like investment (new section 91A(4)).

62. New section 91A(5) and (6) describes what is meant by outstanding obligations. They are undischarged obligations to meet calls on the

shares or to make any other form of capital contribution. But the obligation must be one that is required to be met by a person other than the holder of the shares (the third party), so that any meeting of the unpaid calls etc. increases the value of the shares without any contribution by the shareholder.

63. New section 91A(7) and (8) defines what is meant by interest-like investment. It is where a share's nature is such that its fair value is likely to increase at a rate which represents a return on an investment at a commercial rate of interest (see paragraph 155 below), and is also unlikely to deviate to a substantial extent from that rate of increase.

64. The rate of increase and the deviation are judged without taking into account fluctuations in value resulting from changes in exchange rates, and on the assumption that there will be no value–shifting transactions.

65. New section 91A(10) treats a person as continuing to hold shares when they are out on repo or stock loan, or if they have been mortgaged.

66. Paragraph 10(3) inserts a new section 91B into FA 1996.

67. New section 91B(1) sets out the case. It is where a company (called the "investing company") holds shares in another company (called the "issuing company"):

- which do not fall, by virtue of paragraph 4 Schedule 10 FA 1996, to be treated as rights under a creditor loan relationship of the company
- to which section 91A does not apply,
- which are non-qualifying shares (as to which see paragraph 72)

68. Where the case applies, new section 91B(2) says that the share is treated as a creditor loan relationship for the purposes of Chapter 2 Part 4 FA 1996, and any distribution is not a distribution within section 209(2)(a) or (b) ICTA 1988 (and so is not exempt from corporation tax by virtue of section 208 ICTA).

69. For that purpose, a fair value method of accounting must be used for tax purposes (new section 91B(3)).

70. New section 91B(4) provides that in a Condition 1 case (see paragraph 77 below) no debits are brought into account in respect of a transaction intended to stop the fair value of the share increasing at a rate which represents a return at a commercial rate of interest

71. New section 91B(5) ensures that in a Condition 3 case (see paragraph 96 below) debits and credits on a fair value basis are to be brought into account in respect of any associated transaction as if it were a derivative contract (where that is not in fact the case).

72. A share is a non-qualifying share for the purposes of this section if it meets at least one of the three Conditions in section 91C to E - new section 91B(6)(b).

73. Shares which are ones where any distribution and increase in value is already brought into account are not within the section. This is the case for certain dealers in securities and other financial concerns such as banks (section 95 ICTA) – new section 91B(6)(a).

74. New section 91B(7), by praying section 91A(10) in aid, treats a person as continuing to hold shares when they are out on repo or stock loan, or if they have been mortgaged.

75. Paragraph 9(4) inserts new sections 91C to 91E into FA 1996

76. Section 91C sets out the first of three Conditions, one of which a share must meet to make a share a non-qualifying share.

77. Condition 1 (new section 91C(1)) is similar to that in section 91A(7). It is where the assets of the issuing company are not income producing (see paragraph 79 below) but are of such a nature that the fair value of the share is likely to increase at a rate which represents a return on an investment at a commercial rate of interest, and is also unlikely to deviate to a substantial extent from that rate of increase.

78. The rate of increase and the deviation are judged without taking into account fluctuations in value resulting from changes in exchange rates, and on the assumption that there will be no value –shifting transactions intended to cause the condition in section 91C(1) not to be met – new section 91C(5).

79. New section 91C(2) provides that assets are not income producing if they are:

- a share which satisfies the conditions in new section 91A (shares subject to third-party obligations which increase in value in an interest-like way),

- a share which satisfies Condition 2 in new section 91D, (certain redeemable shares)

- a share which satisfies Condition 3 in new section 91E (shares which in combination with derivatives etc increase in value in an interest-like) way,

- any asset within paragraph 8(2) Schedule 10 FA 1996 (money placed at interest, securities and certain holdings in collective investment vehicles).

80. New section 91C(3) allows the Treasury to make regulations amending section 91C so as to add further types of asset that are "income producing" for the purposes of subsection (2). New section 91C(4) provides that any such regulations may be made so as to have effect for periods ending after they come into force whenever the period began.

81. New section 91C(6) requires the section to be construed as one with section 91B.

82. Condition 2 (new section 91D(1)) is that the share is redeemable, is designed to produce a return which equates, in substance, to the return on an investment of money at a commercial rate of interest, and is not an excepted share (see paragraph 84 below).

83. New section 91D(2) defines which shares are regarded as redeemable for these purposes.

84. New section 91D(3) sets out the three classes of excepted share for the purposes of new section 91D(1). A share is excepted if –

    - it is a qualifying publicly issued share,

    - it is a share that mirrors a public issue, or

    - the investing company's purpose in acquiring the share is not an unallowable purpose.

85. New sections 91D(4) to (7) dealing with the first two categories of excepted shares ensure that where a company issues shares into the market, then subject to certain conditions, those shares are never within Condition 2, nor are shares issued within a group of companies to move finance raised by that public issue into the required company within the group.

86. A share is a qualifying publicly issued share where it was issued by a company as part of an issue to independent persons (defined as a person

not connected with the company) and the investing company and persons connected with it hold less than 10% of that issue – new section 91D(4).

87. New section 91D(5) to (7) define the two Cases where a share mirrors a public issue.

88. Case 1 is where a company (A) issues shares to independent persons (the public issue) and within 24 hours of that issue, other group companies issue shares (the mirroring shares) to company A on the same or substantially the same terms as the public issue and the total nominal value of the mirroring shares does not exceed the nominal value of the public issue - new section 91D(6).

89. Case 2 expands the range of mirroring shares to allow for chains of shares to be issued within a group – new section 91D(7).

90. New section 91D(8) and (9) provide for determining when an investing company's purpose for acquiring a share is to be taken to be an unallowable purpose. This is where the purpose, or one of the main purposes, for which the company holds the share is –

   - except where the share is a qualifying publicly issued share, to circumvent section 95 ICTA 1988 (see paragraph 91 below), or
   - a tax avoidance purpose.

91. The cases where the purpose, or one of the main purposes, is taken to be circumventing section 95 ICTA 1988 includes the case where, at the time the company acquired the share, it was associated with a "credit institution" and, had that credit institution itself acquired the share, it would have been held in circumstances such that section 95 ICTA applied.

92. A "tax avoidance purpose" follows the well understood approach in paragraph 13 Schedule 9 FA 1996 ie any purpose that consists in securing a tax advantage (whether for the company or anyone else).

93. New section 91D(10) provides definitions for the section. In particular, a "credit institution" is defined to include a bank, and building society and a person authorised to carry on consumer credit business. A person is "associated" with a credit institution if they are in the same "group relief" group.

94. New section 91D(11) applies section 839 ICTA 1988 (connected persons) for the purpose of determining who are "independent persons" – see paragraph 86 above.

95. New section 91D(12) requires the section to be construed as one with section 91B.

96. Condition 3 (new section 91E(1)) is that there is a scheme or arrangement under which the share and one or associated transactions are together designed to produce a return which equates, in substance, to the return on an investment of money at a commercial rate of interest.

97. New section 91E(2) defines associated transaction as including entering into, or acquiring rights or liabilities under any of the following:

- a derivative contract;
- a contract that would be a derivative contract, apart from paragraph 4(2B) Schedule 26 FA 2002, ie the contract hedges a holding of shares held other than for trading purposes;
- a contract having a similar effect to the contracts in the two bullets above;
- a contract of insurance or indemnity.

98. New section 91E(3) requires the section to be construed as one with section 91B.

99. Paragraph 10(5) inserts a new section 91F into FA 1996, allowing the Treasury by regulations to amend the loan relationships rules to add, vary or remove Conditions for the purposes of section 91B(6)(b).

100. New section 91F(2) enables amendments to be made which are consequential upon adding, varying or removing a Condition. The provisions which can be so amended are:

- the loan relationships regime in Chapter 2 Part 4 FA 1996,
- Chapters 1 to 3 of Part 6 of ICTA (company distributions),
- Part 18 of ICTA (double tax relief),
- the TCGA, and
- the derivatives contracts regime in Schedule 26 FA 2002.

101. As is usual, the regulations may make different provision for different cases, and make consequential, supplementary, incidental or transitional provisions, or savings, as appears necessary or expedient. The power includes a power to amend any enactment or any instrument made under an enactment – new section 91F(3).

102. Paragraph 10(6) inserts a new section 91G into FA 1996

103. This gives the rules for when shares move into or out of the section 91A or 91B regime without any change in ownership, and also the transitional rules.

104. Where shares become ones to which section 91A or 91B apply after 16 March 2005 a chargeable gain is triggered as a result of a deemed disposal for fair value – new section 91G(1). There is also a deemed reacquisition.

105. Where shares cease to be ones to which section 91A or 91B apply, there is a deemed disposal for fair value for the purposes of the loan relationships rule (and TCGA but it has no effect) and there is also a deemed reacquisition for fair value, which has effect for TCGA – new section 91G(2).

106. New section 91G(3) to (6) gives the rule on entry on 16 March 2005 into either of section 91A or 91B. Here the provisions of paragraph 5 Schedule 10 FA 1996 are copied. The event is treated as one to which section 116 TCGA applies. This means that section 116(10) applies. The capital gain that would have accrued if the shares had been sold immediately before section 91A or 91B applied to them is brought into account on their eventual disposal (or, subject to paragraph 107 below, when the shares cease to be ones to which section 91A or 91B apply, because of the deemed disposal of the "new" asset by virtue of section 91G(2)).

107. New section 91G(7) provides a transitional rule to enable companies to unwind arrangements to which sections 91A or 91B apply. It provides that where shares became subject to either section 91A or 91B on 16 March 2005, but the shares cease to be ones to which either section applies at any time on or before 31 December 2005, the capital gain that would have accrued on the 15 March 2005 is not treated as accruing at that point but is treated as accruing when the shares are subject to any future disposal.

108. Paragraph 10(7) provides that the seven new sections apply where shares within their scope are held on or after 16 March 2005.

109. Paragraph 5 makes a consequential amendment to section 807A ICTA 1988 to ensure the double tax relief rules work correctly where a share is treated as a loan relationship under new sections 91A or 91B FA 1996, so as to disregard foreign tax in respect of a distribution which accrues at a time when the company did not hold that share.

110. Paragraph 5(1) is introductory.

111. Paragraph 5(2) inserts a new sub-section (2B) into section 807A ICTA 1988 which provides that where a share is treated by new sections 91A or 91B FA 1996 as a loan relationship, the section applies to distributions accruing on those shares at a time when the company does not hold the share as it applies to interest accruing under a loan relationship at a time when the company is not a party to that loan relationship.

112. Paragraph 5(3) gives the commencement rule. It is the same as for paragraph 10. Paragraph 5 applies where shares within section 91Aor 91B are held on or after 16 March 2005.

113. Paragraph 9 deals with certain TCGA consequences of section 91A. Because the shares must be subject to third party obligations it is possible for a share to come within section 91A if the holder, being a person with the obligations, transfers the share to another without transferring the obligations. And vice versa.

114. If the companies are members of the same group, it is necessary to prevent section 171 TCGA (no gain/no loss disposal between group members) applying in this case, as otherwise potential gains might drop out of account altogether.

115. Accordingly paragraph 9 amends section 171 TCGA, and paragraph 9(2) inserts a new section 171(3A) which prevents the section from applying to a transfer of a share which becomes a section 91A share in the hand of the transferee, and to the converse case.

116. Paragraph 9(3) gives the commencement rule – it applies to disposals on or after 16 March 2005.

Background

117. These paragraphs deal with a number of schemes disclosed under Part 7 FA 2004 and elsewhere which exploit the fact that increases in value and gains from the disposal of shares are subject only to the rules for corporation tax on chargeable gains, if at all. The schemes use derivatives in conjunction with shares, or deferred subscription

agreements to create what is in form a share but in economic substance a deposit or loan, since in most of them the risks associated with equity investments, as well as the rewards, are removed or significantly reduced, leaving the share giving a return, either by the payment of "dividends" or by a wholly predictable increase in value, which is the type of return expected from debt.

118. These provisions have to be viewed in conjunction with the Finance Act 2002, Schedule 26, Parts 2 and 9 Order 2005 (SI 2002/646) laid before Parliament on 16 March 2005 which changes the treatment of derivatives whose underlying subject matter is shares.

Paragraph 11: Manufactured interest

Detail

119. Paragraph 11 removes the restriction that the only debits and credits that may be brought into account where a company has the right to receive manufactured interest are those relating to that interest. This change means where a company realises the value of the right to receive manufactured interest under a related transaction, such as selling that right, the profit can be taxed.

120. The changes apply to related transactions on or after 16 March 2005.

121. Paragraph 11(1) provides that section 97 FA 1996 is amended.

122. Paragraph 11(2) repeals section 97(2)(b) FA 1996 which restricted credits and debits to those relating to manufactured interest, and makes a consequential amendment to the full-out words of the sub-section.

123. Paragraph 11(3) inserts a new sub-section (2A) which ensures that where a company no longer has the right to receive manufactured interest because it has sold or transferred that right, section 97 continues to apply for the purpose of bringing into account credits in respect of related transactions.

124. Paragraph 11(4) repeals subsections (3) and (3A) which determine whether debits and credits brought into account under the section are trade debits or credits. These rules are unnecessary as the general loan relationships rules will determine that point.

125. Paragraph 11(5) provides that these changes apply to related transactions on or after 16 March 2005.

Background

126. This paragraph changes the loan relationships rules relating to the taxation of manufactured interest.

127. Manufactured interest is a payment made under a contract or arrangement for the transfer of securities and which represents interest paid on that security. Such a payment is commonly made under standard repo or stock lending agreements used in the financial markets.

128. The section, which taxes and relieves manufactured interest, only brought into account debits and credits which were "relating to that interest".

129. It has become apparent from avoidance disclosures relating to repos and stock lending that companies might seek to take advantage of this restriction by arranging to realise the value of the right to receive manufactured interest in ways that arguably do not give credits 'relating to that manufactured interest', such as selling the right to a third party (a related transaction).

130. The change blocks such avoidance schemes by removing the restrictions on credits that can be brought into account, so that if a right to receive manufactured interest is sold or transferred under a related transaction, then the profit from that transaction can be brought into account.

Paragraph 12:money debts: discount and profits from interest

Detail

131. Paragraph 12 amends section 100 Finance Act 1996. This section hitherto has treated amounts of interest and exchange gains and losses on debts which are not themselves loan relationships (that is debts arising from a transaction of lending money or other debentures) as within the scope of Chapter 2 Part 4 FA 1996; and deems the money debts on which the amounts arise to be a loan relationship for the purposes of the CT Acts. Paragraph 12 adds profits from disposals of interest and from all discounts to the types of profits falling within section 100.

132. Paragraph 12(1) is introductory.

133. Paragraph 12(2) provides for section 100(1)(c) to be amended by adding a new sub-paragraph (iv) which brings amounts to which new section 100(1A) applies within the scope of section 100. Note that section 100(1)(c)(iii) was added by paragraph 9(3) Schedule 4 FA 2005 to include impairment losses in section 100.

134. Paragraph 12(3) then inserts a new subsection (1A) into section 100 to limit the amounts included in section 100(1)(c)(iv) to cases where:

- the company is a creditor (and so the money debt is an asset);
- the money debt is one from which a discount arises;
- the discount does not fall to be brought into account by virtue of section 47 & 50 FA 2005 (alternative finance return);
- the money debt is not a trading debt;
- the money debt is does not arise from the disposal of property which is a loan relationship or a derivative contract.

135. Paragraph 12(4) adds to the types of income included in section 100(2) any amounts within section 100(2ZA).

136. Paragraph 12(5) inserts new subsections (2ZA) and (2ZB) into section 100.

137. New section 100(2ZA) provides that not only amounts of interest and discount are themselves within section 100 but so are profits (but not losses) from any related transactions in respect of a right to receive interest and any related transaction affecting the discount. The subsection also brings in debits in respect of impairment of discount and credits for any reversal of that impairment.

138. “Related transaction” means any disposal or acquisition of rights or liabilities under the loan relationship as given by section 84(5) FA 1996.

139. New section 100(2ZB) makes it clear that the disposal of all the rights to receive interest does not prevent the money debt being one to which section 100 applies.

140. Paragraph 12(6) inserts new sections 100(3A) and (3B). Section 100(3A) gives a particular instance of where a discount arises. It is where a company disposes of property for a deferred consideration, where that deferred consideration is greater than the amount that would have been paid for the property if the price had been paid at the time of disposal and the difference, the excess, represents a return on an investment of money at interest.

141. In other words there is compensation to the vendor for being out of his money in the form of an increased amount of sale price and this increase

is treated as being a discount for the purposes of the amendments to section 100.

142. New subsection (3B) provides that where discount is brought into account for the purposes of section 100 the creditor loan relationship concerned must be accounted for, for tax purposes, on an amortised cost basis of accounting.

143. Paragraph 12(7) and (8) omits a number of subsections of section 100 which became redundant when section 100(2) was rewritten by Finance Act 2002 to provide that the relationship to which section 100 applied was treated for the purposes of Chapter 2 Part 4 FA 1996 as a loan relationship. The provisions concerned are subsections (4), (5), (6), (8) and (13).

144. Paragraph 12(9) makes a consequential amendment. Because discount, not arising from a loan relationship but on a money debt, now falls within section 100 and therefore Chapter 2 Part 4 FA 1996, it is no longer necessary to have a separate head of charge in the CT version of Case III of Schedule D separate from the charge on loan relationships and so paragraph (c) of Case III in section 18(3A) ICTA is omitted.

145. Paragraph 12(10) gives the general commencement rule which is that the amendments have effect in relation to any money debt which is an asset on or after the commencement date – which, by virtue of paragraph 12(13) is 16 March 2005.

146. Paragraph 12(11) ensures that there is a proper fit between the amendments made by this paragraph and those made by Schedule 4 FA 2005 which have a different commencement date.

147. Paragraph 12(12) is a transitional provision which exempts from the new provision:

- any discount arising from a money debt which accrued before 16 March 2005,
- any loss arising from impairment, or profit from reversal of such impairment, of discount which accrued before that date, and
- any profits from related transactions in either the right to receive interest or discount which took place before that date.

148. Paragraph 7 makes a consequential amendment to section 48 TCGA (consideration due after time of disposal).

149. Paragraph 7(2) forms section 48 into a new subsection (1). Paragraph 7(3) then inserts new subsections (2) to (4).

150. New section 48(2) overrides the rule in subsection (1) (deferred consideration to be brought into account without any discount for deferral) in relation to consideration which consists of rights under a creditor loan relationship to which a company becomes party as a result of the disposal. This will be the case where the consideration is any debenture or a simple money debt on which interest, exchange gains and losses or discount arises.

151. New section 48(3) provides that the amount to be brought into account in respect of the consideration in computing any chargeable gain is the fair value of the creditor relationship.

152. New section 48(4) defines "creditor relationship" and "fair value" as having the meanings given in Chapter 2 Part 4 FA 1996.

Background

153. Section 100 FA 1996 as originally enacted in FA 1996 treated any interest that arose on a money debt (a simple debt) which did not arise from a transaction for the lending of money or was a debenture as falling within Chapter 2 Part 4 FA 1996 (loan relationships) ("Chapter 2"). Examples include interest on a judgement debt, interest on unpaid and overpaid tax and interest on a trade debt. the In FA 2002 it was extended to cover exchange gains and losses on a simple debt, as they had been within the Forex legislation in Chapter 2 Part 2 FA 1993 which was then subsumed into the loan relationships legislation. FA 2002 also provided that any simple debt on which interest or exchange gains and losses arise was deemed to be a loan relationship for all the purposes of Chapter 2, thus allowing all the computational rules in Schedule 9 FA 1996 to apply.

154. Disclosures under Part 7 FA 2004 have indicated that a number of tax avoidance schemes have been devised to exploit the limited scope of section 100 and a possible gap in the legislation dealing with discounts in section 18(3A) ICTA. Paragraph 12 is intended to expand the scope and close any gaps.

Paragraph 13: Commercial rate of interest

Detail

155. Paragraph 13(1) provides a definition of "commercial rate of interest" for the purposes of the loan relationships regime, by inserting a new sub-sections (3A) and (3B) into section 103 FA 1996.

156. New section 103(3A) defines a commercial rate of interest, in relation to a company and any asset, as either –

- a rate ("the simple commercial rate") which is reasonably comparable to the rate the company could obtain by placing on deposit the money it invested in the asset, or

- where looking at the likely rate of increase in the value of the asset, and that likely rate is lower than the simple commercial rate because the company expected to obtain a tax advantage from investing in the asset, that lower rate.

157. New section 103(3B) defines tax advantage for the purposes of subsection (3A).

158. Paragraph 13(2) applies the definition of commercial rate of interest in relation to assets held on or after 16 March 2005 (whenever acquired).

Paragraphs 14 & 20: Capital redemption policies

Detail

159. Paragraph 14 amends Schedule 9 FA 1996 in respect of capital redemption policies.

160. Paragraph 14(1) removes paragraph 1A(1)(b) Schedule 9 FA 1996 from that Schedule, so that capital redemption bonds ("CRBs") are no longer excluded from Chapter 2 Part 4 FA 1996 (the loan relationships legislation) which applies to companies.

161. Paragraph 1A was inserted into Schedule 9 FA 1996 by paragraph 21 Schedule 25 Finance Act 2002. So far as CRBs are concerned this was done to ensure that the rules for "chargeable events" in Chapter 2 Part 13 ICTA continued to apply.

162. Instead, the loan relationships legislation will now apply. By virtue of section 80(5) FA 1996 and section 547(2) ICTA there can be no question of a chargeable event gain arising. By virtue of section 80(5) FA 1996 and section 117(A1) TCGA there can be no question of a chargeable gain

or allowable loss arising (the CRB being treated as a qualifying corporate bond exempt under section 115 TCGA).

163. In order to retain the neutrality of the I minus E computation, paragraph 20(2) provides that a new paragraph (1C) is inserted into Schedule 11 FA 1996. This provides for the disregard of the BLAGAB credits and debits on a CRB which is a debtor relationship of an insurance company.

164. Paragraph 14(3) and 20(3) provide that the new rules apply from 10 February 2005, and paragraph 14(4) introduces the transitional rules for the case where a CRB is held on 10 February, having also been held on 9 February. Paragraph 14(5) treats the company whose CRBs come within the loan relationships rules from 10 February 2005 as having assigned all the rights in the policy on 9 February for a consideration equal to the bond's carrying value in the company's accounts, and gives the same value as the opening loan relationships amount. The chargeable event gain arising is deferred until the accounting period when the policy matures, or is actually assigned or surrendered if that is later– paragraph 14(6).

165. Paragraph 14(7) gives definitions of "assignment" and "carrying value".

Background

166. It has become clear as a result of disclosures made to the then Inland Revenue under Part 7 Finance Act 2004 and otherwise that corporate held CRBs are being used to manufacture an alleged artificial allowable loss for the purposes of corporation tax on chargeable gains. The creation of the loss depends crucially on the proposition that a CRB is not exempt from tax under TCGA and on the interaction of TCGA and the chargeable event rules. The then Inland Revenue, now HM Revenue and Customs, does not accept that these stratagems succeed in their object, but in order to bring clarity and finality to the issue, CRBs will be taken outside the chargeable event rules and the provisions of the TCGA.

167. CRBs are a form of investment or deposit offered by an insurance company. They are not life assurance policies as they contain no element of contingency on human life. But they are deemed to be insurance for regulatory purposes, in order that an insurance company, which is not permitted by the rules made by the Financial Services Authority and EC Insurance Directives to carry on business which is not insurance business, may write such business. They are also regarded as a "policy of insurance" for the purposes of section 759(5)(b) ICTA (offshore funds), because they fall instead within the offshore policy regime in section 553 ICTA.

168. A CRB is one example of a "capital redemption policy" to which the chargeable event rules in Chapter 2 Part 13 ICTA apply. The income and gains from assets of the insurance company issuing a CRB and referable to its capital redemption business will be charged to tax, so far as referable to the policy holders' interest in the income and gains, at a corporation tax rate of 20 per cent under the "I minus E" basis, unless the policy was entered into before 1 January 1938.

169. Before paragraph 14 applies, a charge to tax will arise on the happening of any of the following events (see section 545(1) ICTA)—

- The maturity of the policy;
- The surrender in whole of the rights conferred by the policy;
- The assignment for money or money's worth of those rights.

170. A charge may also arise on the part surrender or part assignment of those rights, subject to the so-called 5 per cent (of premiums) rule which ensures that small disposals are deferred to a later chargeable event.

171. Where a charge to tax arises, the whole of the gain is brought into account to corporation tax as income chargeable under Case VI of Schedule D – section 547(1)(b) ICTA. No credit or allowance is given for the tax charged on the I minus E basis on the insurance company – section 547(5) ICTA.

172. Under existing law, the obligations of the issuing insurance company to pay the maturity amount are not taken into account for tax purposes (unless the policy was issued before 1 January 1938) except in a computation of the profits of the company's life assurance business under the rules of Case I of Schedule D. Such a computation is made only:

- to determine the rate of tax chargeable on the I minus E basis profits;
- to determine whether a restriction of expenses under Step 9 in section 76(7) ICTA is required;
- to determine whether a Case I loss exists;
- in the case of a pure reinsurer or where the Crown option to assess under Case I is exercised.

Paragraphs 15 to 18 and 22 to 24: Groups of companies etc

Detail

173. Paragraphs 16 to 18 and 22 to 24 amend the rules dealing with groups of companies and introduce a degrouping charge. Paragraph 15 amends the fair value charge where a company ceases to be resident in the UK.

174. Paragraphs 17 and 22 deal with the group continuity rules for loan relationships and derivative contracts.

175. Paragraphs 17(2) and 22(2) substitute a new paragraph 12(2) Schedule 9 FA 1996 and paragraph 28(3) Schedule 26 FA 2002 to the same effect. The purpose of the new paragraphs is to ensure that the value at which an asset moves from a transferor to a transferee is the same on both sides of the transaction and is such as gives rise in the transferor to neither a profit nor a loss. The changes make paragraph 12 Schedule 9 and paragraph 28 Schedule 26 more akin to section 171 TCGA (no gain, no loss on transfer between members of groups of companies), rather than a stand-in-shoes rule which they looked like originally.

176. The new sub-paragraphs provide that the transferor is treated as having entered into the transaction for a consideration which is equal to the notional carrying value of the asset or liability or the derivative contract, as the case may be. The notional carrying value is the amount that would have been shown in the balance-sheet of the transferor for the asset or contract concerned if a set of accounts had been drawn up on the date of transfer. This carrying value will represent the amortised cost of the asset. But it will be subject to any adjustment for tax purposes as a result of the insertion in paragraph 12(9) Schedule 9 FA 1996 by paragraph 17(5) of a definition of carrying value to give it the same meaning it has for paragraph 19A Schedule 9. An equivalent insertion is made by paragraph 22(3) into paragraph 28(5) where the definition of carrying value refers to paragraph 50A Schedule 26.

177. The new paragraphs 12(2) Schedule 9 FA 1996 and 28(3) Schedule 26 FA 2002 then go on to provide that, for the transferee, the transferor's carrying value is used as the acquisition cost for all accounting periods in which it is a party to the loan relationship. This means that where the transferee uses fair value accounting the movement in fair value in the accounting period of transfer will be the difference between the fair value at the end of that period and the carrying value to the transferor of the asset and where amortised cost is used then the carrying value of the transferor will be used as the cost to the transferee.

178. Paragraph 17(6) and 22(4) ensure that the definition of "carrying value" has proper effect for periods of account beginning before 1 January 2005. This is because paragraphs 19A Schedule 9 and 50A Schedule 26 which contain the meaning of carrying value only have effect for periods beginning on or after 1 January 2005.

179. Paragraph 17(3) makes a consequential amendment to the part of Schedule 9 (sub-paragraph (2A) that relates to the case where the transferor uses fair value accounting).

180. Paragraph 17(4) inserts a definition of member of a group of companies by substituting a new paragraph 12(8) Schedule 9. This arises because of changes made to paragraph 11 Schedule 9 – see paragraph 184 below.

181. Paragraph 17(7) and 22(5) give the general commencement rule, which is that the amendments have effect where the relevant transaction is on or after 16 March 2005. Paragraphs 17(8) and 22(6) define "relevant transaction" to mean whichever of the particular types of transaction mentioned in paragraph 12 Schedule 9 or paragraph 28 Schedule 26 is in point.

182. Paragraph 23 deals with minor amendments to paragraph 30 Schedule 26. Paragraph 23(2) makes an amendment equivalent to that made by paragraph 17(3) to paragraph 12(2A) Schedule 9 – see paragraph 179 above.

183. Paragraph 23(3) gives the commencement rule for this amendment, which is the same as for paragraph 22 (see paragraph 181 above).

184. Paragraph 16 amends paragraph 11 Schedule 9 FA 1996 (transactions not at arm's length). As it stands paragraph 11 does not apply where a transaction is between members of a group of companies. This was intended as a rule to ensure that paragraph 12 Schedule 9 FA 1996 has priority over paragraph 11, but the exclusion in paragraph 11 Schedule 9 is not restricted to cases where paragraph 12 Schedule 9 applies. There can be, as evidenced by Part 7 FA 2004 disclosures, cases where there is a transaction between groups of companies to which paragraph 12 Schedule 9 does not apply and which therefore slip down the middle: neither requiring to be brought into account for tax at a no gain no loss consideration nor at fair value.

185. Accordingly, paragraph 16(2) inserts a new paragraph 11(3) into Schedule 9 in place of the existing paragraph 11(3).

186. New paragraph 11(3) provides that the operative rule in paragraph 11(1) Schedule 9 (fair value to be used in non-arm's length transactions) does not apply if the transaction is one to which paragraph 12 Schedule 9 applies or would apply but for the fact that the transferor uses fair value accounting (and so fair value is already being used for tax purposes and paragraph 11(1) is unnecessary).

187. Paragraph 16(3) omits paragraph 11(5) Schedule 9 which refers to members of a group (and as a result that definition is now included as paragraph 12(8) Schedule 9 by virtue of paragraph 17(4) of this Schedule).

188. Paragraph 16(4) provides that these amendments have effect where there is a related transaction on or after 16 March 2005.

Background

189. The loan relationship and derivative contract regimes contain provisions that allow the transfer of loan relationships or derivative contracts between group members without a tax charge. Instead of a charge on disposal, the transferee company "steps into the shoes" of the transferor. After the transfer, any profit or loss made by the transferee from the loan relationship is based on the original amount paid by the transferor for entering into it. These rules prevent the legislation from inhibiting group reorganisations and ensure that losses cannot be crystallised by effecting a transfer intra-group.

190. The avoidance disclosure rules introduced in FA 2004 have revealed avoidance schemes designed to exploit these rules. Some considered that companies were able to obtain a 'step-up' in the value of a loan relationship or a derivative contract. Where a company using an accruals basis of accounting transferred a loan relationship or a derivative contract to a company accounting at mark to market, the disclosures indicated that the increase in value was not brought into charge. This analysis is not accepted but changes have been made to clarify the treatment.

191. The new rules make clear that the value of a transferred asset is the same for the transferor and the transferee. Rather than a rule that requires the transferee to 'step in the shoes' of the transferor, the new rule works more like a transfer at no gain and no loss.

192. Changes are also made to paragraph 11 Schedule 9 FA 1996. This change only applies to loan relationships as there is no similar rule for derivative contracts.

193. Paragraph 11 Schedule 9 is an arm's length rule. It does not apply where transactions are between group members or where the transfer pricing rules in Schedule 28AA ICTA 1988 apply. Transactions between group members are excluded so that the arm's length rule does not prevent paragraph 12 Schedule 9 from working correctly to make intra-group transactions tax neutral. Avoidance disclosures have shown that the arm's length rule has been prevented from working in rare circumstances where paragraph 12 does not apply. The exclusion from the arm's length rule has therefore been rewritten to work as originally intended.

Paragraphs 15, 18 & 24: Degrouping charge

Detail

194. Paragraphs 18 and 24 introduce a degrouping charge into the loan relationships and derivative contracts regimes.

195. Paragraph 18(1) provides for the insertion into Schedule 9 FA 1996 of a new paragraph 12A.

196. New paragraph 12A(1) gives the case. It is where paragraph 12 has applied in relation to a transaction between members of a group (but not where it applies only in relation to an insurance business transfer) and where, within a period of six years, the transferee company ceases to be a member of the group.

197. New paragraph 12A(2) is the operative part. It provides that Chapter 2 Part 4 has effect as if that transferee company had assigned the asset or liability for fair value immediately before it ceased to be a member of the group and then reacquired the asset or liability for that same consideration immediately after.

198. But the operative rule only applies if, as a result of applying it, Condition 1 or 2 is satisfied (see paragraphs 199 and 200 below) and new sub-paragraph (5) (see paragraph 201 below) does not apply.

199. Condition 1 is that if the operative rule applies, a credit would be brought into account by the transferee company – new paragraph 12A(3) of Schedule 9 FA 1996.

200. Condition 2 is that the loan relationship is a creditor relationship and as a result of applying the operative rule a debit would be brought into account by the transferee company in respect of that relationship but a credit would be brought into account in respect of a hedging derivative

contract under new paragraph 30A Schedule 26 FA 2002 (see paragraph 208 below) – new paragraph 12A(4) of Schedule 9 FA 1996.

201. New paragraph 12A(5) applies where a company leaves a group under circumstances where there is an exempt distribution within section 213 ICTA 1988. In such a case, the de-grouping charge does not apply, but if a chargeable payment within section 214(2) ICTA 1988 is made within 5 years, new paragraph 12A(6) applies.

202. New paragraph 12A(6) and (7) reinstates the de-grouping charge that would have arisen at the time the transferee company left the group, but the charge is treated as arising immediately before the chargeable payment is made.

203. New paragraph 12A(8) defines certain terms. In particular it defines the six year period by reference to either a paragraph 12(1)(a) transaction (a simple transfer) or the last in a series of transactions as mentioned in paragraph 12(1)(b).

204. "The relevant group" is also defined to mean the group that is mentioned in the relevant paragraph of paragraph 12(1) Schedule 9.

205. "The relevant loan relationship" and "the transferee company" have the same meanings as they have in that paragraph 12.

206. New paragraph 12A(9) applies paragraph 12(14) of Schedule 26 FA 2002 for the these purposes. That sub-paragraph defines a hedging relationship for the purposes of that Schedule.

207. Paragraph 18(2) gives the commencement date and it is where a company ceases to be a member of a group on or after 16 March 2005.

208. Paragraph 24 inserts a new paragraph 30A into Schedule 26 FA 2002 which does precisely the same as the new paragraph 12A Schedule 9 FA 1996, only it applies to derivative contracts rather than loan relationships.

209. Paragraph 15 amends paragraph 10A Schedule 9 FA 1996 which relates to the fair value charge when a company ceases to be resident in the United Kingdom.

210. Paragraph 15(2) provides a priority rule as between paragraph 10A Schedule 9 and paragraph 12A Schedule 9 which could both apply to the same event and to the same asset or liability and provides that in such a case paragraph 12A has priority.

211. Paragraph 15(3) corrects a typographical error in paragraph 10A(2) substituting “Chapter” for “Schedule”.

212. Paragraph 15(4) gives the commencement date which is that the paragraph has effect on or after 16 March 2005.

Background

213. The loan relationship and derivative contract regimes contain provisions that allow the transfer of loan relationships or derivative contracts between group members without a tax charge. Instead of a charge on disposal, the transferee company “steps into the shoes” of the transferor. After the transfer, any profit or loss made by the transferee from the loan relationship is based on the amount paid by the transferor for entering into it. These rules prevent the legislation from inhibiting group reorganisations and ensure that losses cannot be crystallised by effecting a transfer intra-group.

214. The avoidance disclosure rules introduced in FA 2004 have revealed avoidance schemes designed to exploit these rules. In the simplest scheme, a new group company is set up and a profitable loan or derivative is transferred into it. The transfer does not give rise to a profit because of the rules making intra-group transfers tax neutral. The new company is then sold outside the group. The profitable contract or loan has left the group without giving rise to a tax charge.

215. The sale of the company may give rise to a capital gain but capital losses are usually available to cover the gain. Alternatively, no gain arises because the value of the shares includes the market value of the profitable contract or loan.

216. The new degrouping rules work by deeming a disposal and reacquisition of the contract or loan relationship immediately before the company ceased to be a member of the group. Thus any gain is brought into charge to tax immediately before the disposal of the company.

Paragraph 19: Avoidance Involving Repos or Stock Lending

Detail

217. Paragraph 19 removes the restriction that only credits relating to interest may be brought into account where a company acquires a loan relationship under repo or stock loan. This change ensures that all profits made by such a company in respect of a loan relationship can be taxed.

218. The paragraph also clarifies that only the initial transfer and final transfer back under a repo or stock loan are not to be treated as related transactions.

219. Paragraph 19(1) provides that paragraph 15 Schedule 9 FA 1996 is amended.

220. Paragraph 19(2) amends sub-paragraph (2) to clarify that only the initial transfer under a stock loan or repo and the final transfer back are not treated as related transactions.

221. Paragraph 19(3) makes consequential changes to the wording of paragraph 15(3) Schedule 9.

222. Paragraph 19(4) amends paragraph 15(4A) Schedule 9 so that the person to whom the loan relationship is transferred is not prevented from being treated as a party to that loan relationship.

223. Paragraph 19(5) provides that the changes apply in any case where the acquisition of a loan relationship is on or after 2 December 2004, regardless of when the repo or stock loan was entered into.

224. Paragraph 19(6) provides that a substitution of securities under a repo on or after 2 December 2004 is itself treated as an initial transfer under a repo.

Background

225. This paragraph changes the rules relating to the taxation of assets representing loan relationships transferred under a repo or stock lending arrangement.

226. Sale and repurchase (repo) or stock lending agreements are commonly used in the financial markets to provide secured finance and market liquidity.

227. As the underlying owner of the security retains the economic benefits of that ownership, the tax rules provide that the initial disposal and final reacquisition are ignored for tax purposes provided they are ‘in pursuance’ of the arrangements, and that the original owner remains as a party to the loan relationship in question. The person acquiring the loan relationship (interim holder under a repo, and borrower under a stock loan) is not treated as being a party to the loan relationship, but that does not prevent any credit in respect of interest from being brought into account.

228. The avoidance disclosure rules introduced in FA 2004 have revealed the existence of avoidance schemes designed to exploit these rules. They normally involve a company acquiring a security in the form of a loan relationship under repo or stock loan, but instead of receiving the interest due on that security, the company arranges to realise the value of that interest right in other ways. Most commonly by selling the right to the interest to a financial trader. The company claims that the profit realised from that disposal is not taxable because the credit does not 'relate to interest'.

229. It might also be possible to structure the arrangements so that if the interim holder or borrower transfers the security during the term of the repo or stock loan, it can claim that such a transfer was 'in pursuance' of the repo or stock loan so that any profit on disposal was not taxable.

230. These changes do three things. They:

- clarify that only the initial transfer and final transfer back are not treated as related transactions,
- remove the rule which prevents the interim holder or borrower from being regarded as a party to the underlying loan relationship during the term of the repo or stock loan, and
- remove the restriction that only credits in respect of interest can be brought into account on the interim holder or borrower.

231. The result of these changes is that any profit made by the interim holder or borrower in respect of a loan relationship acquired under repo or stock loan can be taxed.

Paragraphs 8, 21 & 25: Relevant discounted securities: corporate strips

Detail

232. Paragraph 21 extends the rules on relevant discounted securities ("RDS") to strips of bonds issued by other than governments (to which the gilt strips rules already apply). Paragraph 25 provides the equivalent rules for tax years 2005/06 onwards by amending ITTOIA.

233. Paragraph 21(1) provides that Schedule 13 FA 1996 is amended.

234. Paragraph 21(2) provides that the definition of relevant discounted security in paragraph 3 Schedule 13 FA 1996 is subject to new paragraph 13B(1).

235. Paragraph 21(3) provides that the definition of transfer in paragraph 4 Schedule 13 is subject to and does not override new paragraph 13B(2) to (5) which deal with conversion of an interest bearing corporate security into corporate strips and its reconstitution.

236. Paragraph 21(4) ensures that paragraph 5 Schedule 13, which treats conversion of a relevant discounted security as a redemption, does not apply to a conversion of an interest bearing corporate security into corporate strips.

237. Paragraph 21(5) inserts new paragraphs 13A to 13D into Schedule 13.

238. New paragraph 13A deals with the meaning of corporate strip and the process of conversion of an interest-bearing security into corporate strips.

239. New paragraph 13A(1) provides a definition of "corporate strip".

240. New paragraph 13A(2) provides that a person converts an interest-bearing corporate security into corporate strips where as a result of any scheme or arrangements, he comes to have two or more separate assets in place of the converted security, each of those assets satisfies Condition A, and taken together, the separate assets satisfy Condition B.

241. New paragraph 13A(3) provides that Condition A is that the asset represents the right to, or secures, one or more stripped payments.

242. New paragraph 13A(4) defines a "stripped payment" as the payment of, or a payment corresponding to, the whole or part of one or more payments remaining to be made under the converted corporate security.

243. New paragraph 13A(5) provides that Condition B is that the assets, taken together, represent the right to, or secure, every payment (whether of interest or principal) remaining to be made under the converted corporate security, including payments corresponding to every such payment.

244. New paragraph 13A(6) ensures that where a person has an interest-bearing security and sells or transfers the right to one or more payments remaining to be made under it, that is treated as a conversion into corporate strips followed by a sale of one or more of the assets created by that conversion.

245. New paragraphs 13A(7) and (8) apply the rules for corporate strips where a corporate strip is itself stripped.

246. New paragraph 13A(9) ensures that the rules do not apply where an interest bearing security is re-denominated into smaller principal amounts.

247. New paragraph 13A(10) ensures the rules work correctly where an interest-bearing security has gone ex-dividend in respect of the next interest payment.

248. New Paragraph 13B provides that corporate strips are to be relevant discounted securities and gives rules for how the cost and proceeds of disposal of corporate strips are to be calculated.

249. New paragraph 13B(1) provides that every corporate strip is a relevant discounted security.

250. New paragraph 13B(2) and (3) provide the rules for ascertaining the cost of corporate strips. The person converting an interest-bearing security is treated as paying for the acquisition of each corporate strip that proportion of the acquisition cost of that security which the market value of the corporate strip bears to the total of the market value of all the separate assets arising from the conversion.

251. New paragraph 13B(4) provides the rules where an RDS is itself converted into corporate strips. The conversion is treated as a disposal of the RDS for an amount equal to its acquisition cost. This ensures that any discount which had accrued up to the date of conversion is carried through into the cost of the corporate strips and taxed when the corporate strips are disposed of or redeemed.

252. New paragraph 13B(5) provides that where a person consolidates corporate strips into a single security, each corporate strip is treated as redeemed at the time of consolidation by the payment to that person of an amount equal to its market value.

253. New paragraph 13B(6) applies the rules in the paragraph for the purposes of Schedule 13 FA 1996.

254. New paragraph 13B(7) provides that the acquisition cost of a converted corporate security is the amount paid in respect of the acquisition of the security by the person who has it immediately before its conversion, and that costs incurred in connection with the acquisition are not taken into account.

255. New paragraph 13B(8) provides that market value of a security given or received in exchange for, or otherwise converted into, another means its market value at the time of the exchange or conversion.

256. New Paragraphs 13C and 13D apply the anti-avoidance rules introduced in FA 2004 in respect of gilt strips to corporate strips.

257. New paragraph 13C applies where there is a scheme or arrangement in respect of corporate strips and the main, or one of the main, benefits expected to accrue is the obtaining of a tax advantage. The paragraph substitutes market value in any case where the acquisition cost is more than market value, or the disposal or redemption proceeds are less than market value.

258. New Paragraph 13D provides that where, as part of any scheme or arrangement in respect of corporate strips which has an unallowable purpose, a capital loss accrues, that loss is to be disregarded. A scheme or arrangement has an unallowable purpose if the main benefit, or one of the main benefits, that might have been expected to result from it is either the obtaining of a tax advantage or the accrual to any person of a capital loss.

259. For the purposes of new paragraphs 13C and 13D, "tax advantage" has the meaning given by section 709(1) ICTA 1988.

260. Paragraph 21(6) inserts into paragraph 15 Schedule 13 definitions of corporate strip and interest bearing corporate security.

261. Paragraph 21(7) makes consequential changes to the definitions in paragraph 15(1) Schedule 13 FA 1996.

262. Paragraph 21(8) applies the corporate strips rules to corporate strips acquired on or after 2 December 2004, unless acquired under an agreement entered into before that date.

263. Paragraph 25 replicates the effect of paragraph 21 by extending the deeply discounted securities ("DDS") rules in Chapter 8 Part 4 of ITTOIA 2005 to corporate strips. ITTOIA applies for income tax purposes from 6 April 2005.

264. Paragraphs 25(1) to (7) make consequential changes to Chapter 8.

265. Paragraph 25(8) inserts new sections 452A to 452G into ITTOIA 2005. These sections provide for the same rules as new paragraphs 13A to 13C Schedule 13 FA 1996 (see paragraphs 238 to 257 above).

266. Paragraph 23(9) is a consequential which inserts three new defined expressions into Schedule 4 ITTOIA 2005.

267. Paragraph 25(10) provides that ITTOIA has effect as if it had been originally enacted with the amendments made by paragraph 25.

268. Paragraph 8 inserts a new section 151D into TCGA. This has the same effect as new paragraph 13D Schedule 13 FA 1996 (see paragraph 258 above) and prevents creation of an allowable capital loss under any scheme or arrangement in respect of corporate strips.

Background

269. These paragraphs extend the RDS and DDS rules to strips of all securities.

270. Discounted securities are securities where the amount paid on redemption is higher than the price at which they were issued. The difference is the discount and represents the whole or part of the reward to the holder of the security for the use of the money borrowed by the security issuer.

271. Where the discount is more than 0.5 per cent of the redemption amount for each year of the life of the bond, the security is treated as a RDS or DDS for income tax purposes and the discount is taxed as income when it is realised, either on transfer of the security or when it is redeemed.

272. Strips are instruments created by the separation (or ‘stripping’) of an underlying bond into rights to payments of interest at separate future dates during the life of the bond, and rights to payment of the principal at maturity of the bond. Each strip is equivalent to a zero coupon bond.

273. Strips of Government bonds (gilt strips) are treated as relevant discounted securities. Gilt strips can be traded and a gilt can be reconstituted from its component strips. There is a regulated market for gilt strips. There is no regulated market for strips of other types of interest bearing securities and there are no special tax rules for such strips.

274. The avoidance disclosure rules introduced in FA 2004 have revealed the existence of schemes designed to take advantage of this. The schemes involve taking normal interest bearing securities issued by companies, and stripping the rights to some or all of the coupons from away from the right to the principal repayment. The resultant rights have a value which is less than the amount which will eventually be paid by the issuer in

respect of them, and thus produce the effect of discount. But the rights may not be relevant discounted securities because the underlying security from which they derive was not issued at a discount.

275. These new rules block this abuse by applying the RDS and DDS regimes to corporate strips created out of an interest bearing security (other than a Government security). This will ensure that any profit made from disposal or redemption of corporate strips is taxed as income when it is realised.

276. Anti-avoidance measures are included to prevent the profit on a corporate strip escaping the tax charge by using schemes or arrangements to manipulate the cost of acquisition or proceeds on transfer or redemption.

BACKGROUND NOTES

277. In view of the disparate nature of the various changes, background notes on the provisions being amended are included after the detailed notes.

Avoidance Disclosure

278. The disclosure rules were introduced in 2004 Finance Act, along with some transitional arrangements for introduction of the rules. Since the 2004 Budget, HM Revenue and Customs have consulted widely with industry and the professions to ensure that the rules are properly targeted and well understood.

279. The rules for direct taxes focus on two specific areas: employment-related schemes and financial products.

280. The then Inland Revenue, now HM Revenue and Customs, began to receive its first disclosures on direct taxes around September 2004. Following analysis of these disclosures, the Government took action in the 2004 Pre-Budget Report to close a number of schemes and made further announcements on 10 February 2005, as well as on 16 March (Budget Day).

EXPLANATORY NOTE

CLAUSE 40 AND SCHEDULE 8: TRANSFER PRICING AND LOAN RELATIONSHIPS

SUMMARY

1. Clause 40 and Schedule 8 apply transfer pricing rules where parties who collectively could control a business have acted together in relation to the financing arrangements of the business, and to financing arrangements made before a control relationship exists. They also limit the scope of exemptions from loan relationship rules on late payment of interest and discounts by close companies, and extend the definition of creditors identified as connected with debtor companies under these rules.

DETAILS OF THE CLAUSE

2. The clause is introductory only and provides for the Schedule to have effect.

DETAILS OF THE SCHEDULE

3. Paragraph 1 of the Schedule amends Schedule 28AA ICTA 1988. That schedule contains transfer pricing rules, which operate where certain connected parties make provisions between them on a non-arm's length basis.

4. Paragraph 1(1) gives effect to the amendments to Schedule 28AA ICTA 1988 set out in the rest of the paragraph.

5. Paragraph 1(2) amends paragraph 4(2) Schedule 28AA so that the definition of indirect participation in the management control or capital of a business is extended by a new paragraph 4A Schedule 28AA.

6. Paragraph 1(3) inserts a new paragraph 4A in Schedule 28AA. In respect to financing arrangements of a business, this ensures that a person is treated as indirectly participating in the management control or capital of a business if they have acted together with others in relation to financing arrangements of the business and collectively those acting together could control the business. The

purpose of this change is to ensure that in these circumstances the basic transfer pricing rule in paragraph 1 Schedule 28AA applies to provisions relating to the financing arrangements of the business.

7. New paragraph 4A(1) extends the meaning of "indirect participation in management, control or capital", for the purposes of paragraph 1(1)(b)(i) Schedule 28AA, to include circumstances where a number of parties act together in relation to the financing arrangements of a business and collectively they could control the business. (The scope of the application of this extension is limited by new paragraph 4A(7).)

8. New paragraph 4A(2) extends the meaning of "indirect participation in management, control or capital", for the purposes of paragraph 1(1)(b)(ii) Schedule 28AA, to include circumstances where a number of parties act together in relation to the financing arrangements of a business and collectively they could control the business and the other affected person. (The scope of the application of this extension is limited by new paragraph 4A(7).)

9. New paragraph 4A(3) makes clear that persons do not have to be "acting together" at the time a provision is made for the tests in new paragraphs 4A(1) or 4A(2) to be satisfied, if they have acted together in relation to the financing arrangements of the business at an earlier time.

10. New paragraph 4A(4) defines the terms "the relevant time" for the purposes of new paragraphs 4A(1)(d) or 4A(2)(d). It ensures that the tests in new paragraphs 4A(1) or 4A(2) can be satisfied where there is a gap of up to six months between parties ceasing to act together and being in a position where collectively they could control the business (or, where relevant, the other affected person).

11. New paragraph 4A(5) requires that in determining whether parties collectively could control the business or the other affected person for the purposes of new paragraphs 4A(1)(d) and 4A(2)(d), all of the rights and powers that would be taken into account under paragraph 4 in respect of one party should be attributed to all the other parties.

12. New paragraph 4A(6) defines the term "financing arrangements" and makes clear that it extends to arrangements relating in any way to debt, capital or other finance.

13. New paragraph 4A(7) limits the application of the extension to the meaning of "indirect participation in management, control or capital" made by new paragraphs 4A(1) and 4A(2) to provisions relating to financing arrangements.

14. Paragraph 1(4) inserts a new paragraph 4B in Schedule 28AA. This ensures that the basic transfer pricing rule in paragraph 1 Schedule 28AA applies to provisions relating to financing arrangements made up to six months before a relationship exists between the parties to the provision that would otherwise have triggered the application of the rule.

15. New paragraph 4B(1) Schedule 28AA modifies the condition specified in paragraph 1(1)(b) of Schedule 28AA, so that for provisions relating to financing arrangements the condition in that paragraph is satisfied if a relevant control relationship exists within six months of the date on which the provision is made.

16. New paragraph 4B(2) Schedule 28AA ensures that the definition of "financing arrangements" in new paragraph 4A(6) also applies in new paragraph 4B.

17. Paragraph 1(5) inserts new sub-paragraphs (4A) and 4(B) in paragraph 6 of Schedule 28AA.

18. New sub-paragraph (4A) paragraph 6 Schedule 28AA ensures that where transfer pricing rules only apply by virtue of new paragraphs 4A(1) or 4A(2) Schedule 28AA, no claim for a compensating adjustment can be made in respect to a provision relating to a security if the security is guaranteed by a person who has a participatory relationship with the issuer of the security.

19. New sub-paragraph (4B) paragraph 6 Schedule 28AA defines the term "participatory relationship" for the purposes of new sub-paragraph (4A).

20. New sub-paragraph (4C) paragraph 6 Schedule 28AA ensures that new paragraph 4A Schedule 28AA applies for the purposes of establishing whether one person is treated as indirectly participating in the management, control or capital of another when applying the definition of a "participatory relationship" in new sub-paragraph (4B) paragraph 6 Schedule 28AA.

21. Paragraph 2 of the Schedule amends paragraph 2 of Schedule 9 to the Finance Act 1996.

22. Paragraph 2(1) gives effect to the amendments to paragraph 2 of Schedule 9 set out in the rest of the paragraph.

23. Paragraph 2(2) amends paragraph 2(1B) of Schedule 9.

24. Paragraph 2(2)(a) omits certain words from paragraph 2(1B) (the effect of which will now be given in new sub-paragraphs (1F) and (1G)).

25. Paragraph 2(2)(b) amends paragraph 2(1B)(a) to add a person who controls a company participator to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 2(1B).

26. Paragraph 2(2)(c) amends paragraph 2(1B)(b) to add an associate of a person who controls a company participator to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 2(1B).

27. Paragraph 2(2)(d) amends paragraph 2(1B)(c) to add a company controlled by a person who controls a company participator to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 2(1B). It also turns the second part of paragraph 2(1B)(c) (which is not amended) into a new sub-paragraph (1B)(d).

28. Paragraph 2(2)(e) adds a new closing sentence to paragraph 2(1B) to indicate that it is now subject to new paragraph 2(1E).

29. Paragraph 2(3) inserts new sub-paragraphs (1E), (1F) and (1G) in paragraph 2 of Schedule 9.

30. New paragraph 2(1E) provides that the rule in paragraph 2 of Schedule 9, which limits the deduction of debits for late paid interest due to connected creditors of a close company, will not apply in the circumstances described in paragraph 2(1B) if either of the exceptions in new paragraph 2(1F) or new paragraph 2(1G) applies.

31. New paragraph 2(1F) provides the first exception. For this exception to apply, the debtor company must be a CIS-based close company and a small or medium-sized enterprise, and the creditor must not be resident in a non-qualifying territory.

32. New paragraph 2(1G) provides the second exception. For this exception to apply, the debt must be owed to a CIS limited

partnership, no member of that partnership must be resident in a non-qualifying territory (this must be confirmed in writing) and the debtor company must be a small and medium-sized enterprise.

33. Paragraph 2(4) inserts the definitions of "non-qualifying territory", "resident" and "small or medium-sized enterprise" in paragraph 2(6) of Schedule 9.

34. Paragraph 3 of the Schedule amends paragraph 18 of Schedule 9 to the Finance Act 1996.

35. Paragraph 3(1) gives effect to the amendments to paragraph 18 of Schedule 9 to the Finance Act 1996 set out in the rest of the paragraph.

36. Paragraph 3(2) omits sub-paragraph (1)(aa) and sub-paragraph (1)(c) from paragraph 18 of Schedule 9. The effect of these sub-paragraphs is now given in new paragraph 18(1B) and new paragraph 18(1C). The defining phrases that were in the omitted sub-paragraphs are now given as definitions in paragraph 18(4).

37. Paragraph 3(3) amends paragraph 18(1)(b) of Schedule 9.

38. Paragraph 3(3)(a) amends paragraph 18(1)(b)(i) to add a person who controls a company participator to the to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 18(1).

39. Paragraph 3(3)(b) amends paragraph 18(1)(b)(ii) to add a person who is an associate of a person who controls a company participator to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 18(1).

40. Paragraph 3(3)(c) amends paragraph 18(1)(b)(iii) to add a company controlled by a person who controls a company participator to the list of creditors who are regarded as connected with the debtor company for the purposes of paragraph 18(1).

41. Paragraph 3(4) inserts a new paragraph 18(1ZA) in Schedule 9.

42. New paragraph 18(1ZA) provides that the rule in paragraph 18 of Schedule 9, which limits the deduction of debits for discounts on a close company's securities held by connected persons, will not apply in the circumstances described in paragraph 18(1) if any of the exceptions in paragraph 18(1A), new paragraph 18(1B) or new paragraph 18(1C) apply.

43. Paragraph 3(5) amends paragraph 18(1A) to include appropriate new introductory words.

44. Paragraph 3(6) inserts new sub-paragraphs (1B) and (1C) in paragraph 18.

45. New paragraph 18(1B) provides the first new exception. For this exception to apply, the debtor company must be a CIS-based close company and a small or medium-sized enterprise, and the creditor must not be resident in a non-qualifying territory.

46. New paragraph 18(1C) provides the second new exception. For this exception to apply, the debt must be owed to a CIS limited partnership, no member of that partnership must be resident in a non-qualifying territory (this must be confirmed in writing) and the debtor company must be a small or medium-sized enterprise.

47. Paragraph 3(7) inserts the definitions of “CIS-based close company”, “CIS limited partnership”, “non-qualifying territory”, “resident” and “small or medium-sized enterprise” in paragraph 18(4) of Schedule 9.

48. Paragraph 4 of the Schedule applies the changes to transfer pricing and loan relationship rules made by the Schedule with effect from 4 March 2005, subject to some transitional provisions.

49. Paragraph 4(1) applies the changes to transfer pricing and loan relationship rules made by the Schedule to accounting periods starting on or after 4 March 2005, subject to the transitional provisions in paragraphs 4(2) and 4(3).

50. Paragraph 4(2) delays the application of new paragraph 4A Schedule 28AA until 1 April 2007 for debt finance provided under a contract entered into before 4 March that is not varied after that date. This is to provide some transitional protection for such debt finance.

51. Paragraph 4(3) delays the application of the new rules in paragraphs 2(1E), 2(1F), and 2(1G) and paragraphs 18(1ZA), 18(1B) and 18(1C) of Schedule 9 to the Finance Act 1996 until 1 April 2007 to loan relationships under contracts entered into before 4 March that are not varied on or after that date. This is to provide some transitional protection for loan relationships under contracts in place before 4 March.

52. Paragraph 4(4) provides that where a company's accounting period straddles a relevant date (4 March 2005, 1 April 2007 (immediately after the end of the transitional period), or the date when a contract is varied), the company's profits and losses are to be computed as if there were two accounting periods divided by a relevant date. This ensures that the amended rules apply in relation to debits accruing on or after a relevant date.

53. Paragraph 4(5) provides that a change in a contract which does not change the terms of a debtor relationship of the debtor company is not to be regarded as a variation of a contract for the purposes of paragraphs 4(2) and 4(3).

54. Paragraph 4(6) prevents debtor companies making a deduction on or after 1 April 2007 (or on or after the date of a variation of the contract) under the new rules in paragraph 2 or paragraph 18 of Schedule 9 to the Finance Act 1996 if they have already made a deduction for the same amount of interest or discount which would have been disallowed by the new rules but for the application of paragraph 4(3).

55. Paragraph 4(7) modifies paragraph 4 as it applies to a person within the charge to income tax, so that references to an accounting period are read as references to a period of account and one reference to a company is read as a reference to such a person. This ensures that the commencement and transitional provisions apply properly to a person within the charge to income tax.

56. Paragraph 4(8) defines "actual provision", "debtor relationship" and "relevant date" for the purposes of paragraph 4.

BACKGROUND NOTES

57. The transfer pricing rules are contained in Schedule 28AA ICTA, which was introduced by FA 1998 to update previous transfer pricing rules. The rules aim to prevent parties who have a control relationship entering into transactions on a non-arm's length basis to obtain a tax advantage. It has become apparent that a number of parties who collectively control a business can put in place financing arrangements that give rise to a tax advantage, if they act together. The existing transfer rules may not have prevented this where control of a business was shared, and these changes ensure that the rules do apply in such circumstances. A further change ensures that the rules cannot be avoided by putting financial

arrangements in place up to six months before a control relationship exists.

58. The loan relationship rules in the Finance Act 1996 apply for the purposes of corporation tax only to calculate the profits and losses (including any capital profits or losses) on a company's loan relationships. The profits and losses are normally taken from the company's own accounts, subject to certain statutory overrides. There are specific loan relationship rules which limit tax relief for interest which is paid late to a connected party outside the charge to corporation tax and there are exemptions from these rules for amounts payable to certain types of collective investment schemes or by companies owned by these investment vehicles. Similar rules and exemptions apply to discounted securities.

59. The changes made to the loan relationship rules will restrict these exemptions so that they only apply where the debtor company is a small or medium-sized enterprise and the lender is not located in certain territories such as tax havens. The definition of connected party for the purposes of these rules is being extended to include persons who control a participator in the debtor company (and certain connected persons).

EXPLANATORY NOTE

CLAUSE 41: INTANGIBLE FIXED ASSETS

SUMMARY

1. Clause 41 makes a number of changes to the legislation that deals with companies' intangible fixed assets. The changes affect:
    - transfers of intangible assets to or from close companies;
    - transfers of intangible assets between related parties which take place other than at market value;
    - transfers of intangible assets where capital gains tax gifts hold-over relief is claimed; and
    - the availability of capital gains roll-over relief to companies where they acquire payment entitlements under the single payment scheme for farmers.

DETAILS OF THE CLAUSE

2. Subsection (1) provides for the amendments set out in subsections (2) to (4) to be made to Schedule 29 to the Finance Act (FA) 2002 ("Schedule 29") (gains and losses of a company from intangible fixed assets).

3. Subsection (2) inserts four new sub-paragraphs into paragraph 92 of Schedule 29. These new sub-paragraphs create two further exceptions to the rule in paragraph 92(1) that where there is a transfer between a company and a related party of an asset that is a chargeable intangible asset (in the hands of at least one of the parties) then the transfer is treated for all the purposes of "the Taxes Acts" (defined in paragraph 142 of Schedule 29) as being at market value.

4. New sub-paragraph (4A) creates the third exception to this market value rule. It applies if three conditions are satisfied. The first condition is that an intangible asset must either be transferred from a company to a related party at less than market value, or be transferred from a related party to a company at more than market value. The second condition is that the related party must not be a company, or if the related party is a company, the asset transferred must not be a chargeable intangible asset (broadly, an asset within the provisions of Schedule 29) in its hands. The third condition is

that the transfer gives rise (or, but for the market value rule in paragraph 92(1), would give rise) to an amount to be taken into account in computing any person's income, profits or losses for tax purposes by virtue of any provision of section 209 of the Income and Corporation Taxes Act 1988 ("ICTA 1988") (meaning of "distribution") or Part 3 of the Income Tax (Earnings and Pensions) Act 2003 (employment income: earnings and benefits etc. treated as earnings).

5. New sub-paragraph (4B) sets out the consequences when sub-paragraph (4A) applies. It provides that the market value rule in paragraph 92(1) of Schedule 29 does not apply when computing any person's income, profits or losses for the purposes specified in the third condition listed at paragraph 4 above. The computation of income, profits or losses under Schedule 29 is unaffected by this provision.

6. If therefore, for example, a controlling shareholder in a company transfers an intangible asset to the company for £10,000 when the asset has a market value of only £1,000, the amendment ensures that the market value rule in paragraph 92(1) of Schedule 29 does not prevent the shareholder from being taxed on a distribution representing the consideration received for the asset in excess of its value.

7. New sub-paragraph (4C) creates the fourth exception to the market value rule. It applies where an intangible asset is transferred to a company (in whose hands it is a chargeable intangible asset) by a related party and capital gains tax gifts hold-over relief under section 165 of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") is claimed in relation to the disposal. The effect of gifts hold-over relief is to postpone the charge to tax in respect of the chargeable gain that would otherwise have arisen on the disposal. The relief takes effect by "holding over" the appropriate amount of the chargeable gain until the asset is subsequently disposed of by the person to whom the asset is transferred.

8. New sub-paragraph (4D) sets out the consequences when sub-paragraph (4C) applies. In these circumstances the transfer is treated for Schedule 29 purposes as taking place at market value less the amount of the held-over gain. This does not affect the tax position of the person who transfers the asset, but it ensures that a sum equal to the held-over gain is eventually taxed on the company under Schedule 29. Further procedural provision is made

to allow for any necessary adjustments to be made to the tax position of the company as a result of the claim to gifts relief by the person who transferred the asset.

9. Subsection (3) substitutes a new "Case Three" for the existing Case Three in paragraph 95 of Schedule 29. Paragraph 95 sets out the circumstances in which a person ("P") is a related party of a company ("C") for the purposes of Schedule 29. The existing Case Three applies where C is a "close company" (very broadly, a family company) and P is a "participator" (broadly an investor), or an associate of a participator, in C. The new Case Three applies not only in those circumstances but also where P is a participator, or an associate of a participator, in a company that has control of, or a major interest in, C. The terms "associate" and "participator" have the meaning given by section 417 of ICTA 1988 (with one restriction made by paragraph 100(1) of Schedule 29). The definition of a "close company" in sections 414 and 415 of ICTA 1988 applies.

10. Subsection (4) amends paragraph 132(5) of Schedule 29. Paragraph 132(5) provides that, for corporation tax purposes, chargeable gains cannot be rolled over under section 152 or 153 TCGA 1992 against the acquisition of certain classes of intangible asset which fall within Schedule 29 (the disposal of which will effectively be outside the capital gains code). Subsection (4) adds one further class of asset to those listed in paragraph 132(5) of Schedule 29. The class of assets concerned comprises Class 7A of section 155 TCGA 1992 (payment entitlements under the single payment scheme for farmers).

11. Subsection (5) amends section 86 of the Finance Act 1993. Section 86 contains the power which allows further classes of assets to be added to section 155 TCGA 1992 by Treasury order, and consequential amendments to be made to Schedule 7AB to that Act. The amendment to section 86(2) will ensure that where future additions are made by Treasury order to the classes of assets listed in section 155 TCGA, any necessary consequential changes may also be made to Schedule 29 by the same order, thereby obviating the need for further primary legislation.

12. Subsection (6) provides that the amendments made by subsection (2) have effect in relation to any transfer of an asset made on or after Budget day.

13. Subsection (7) provides that for the purposes of the market value rule in paragraph 92 of Schedule 29 (see paragraph 3 above), as it applies otherwise than for determining debits or credits to be brought into account under that Schedule, the amendment made by subsection (3) applies to any transfer of an asset taking place on or after Budget day.

14. Subsection (8) provides that the amendment has effect for all other purposes of Schedule 29 in relation to the debits or credits to be brought into account for accounting periods beginning on or after Budget day. In addition, for these other purposes, the rules of the Schedule are applied to sums arising on or after Budget day as if the amendments were part of the Schedule as originally enacted in 2002.

15. By way of an example of the effect of subsection (8), an asset which fell within Schedule 29 in the hands of a company to which it was transferred prior to Budget day, only because the transferor was not a related party of the transferee at the time, will lose that status for debits or credits to be brought into account on or after Budget day if the parties become related to one another as a result of the amendment.

16. Subsection (9) provides that for the purpose of identifying the debits or credits to be brought into account under subsection (8) (and for no other purpose) an accounting period of a company is deemed to end immediately before Budget day and another to commence on that day.

17. Subsection (10) provides that the amendment made by subsection (4) will have effect in relation to any acquisition on or after 22 March 2005 of assets that are chargeable intangible assets within Class 7A of section 155 TCGA 1992. This is the date when Class 7A was added to section 155 TCGA 1992.

18. The amendments made by subsection (5) will have effect when Royal Assent is given to the Finance Act (No 2) 2005.

BACKGROUND NOTES

19. The intangible fixed assets regime was introduced in Finance Act 2002, following consultation, and is contained in Schedule 29 to that Act. It deals with the corporation tax treatment of intangible

fixed assets such as patents, trade marks and design rights as well as the tax treatment of goodwill.

20. This clause makes changes in a number of areas where amendment is needed to prevent unintended tax relief being given.

21. In broad terms, relief under Schedule 29 is available for intangible fixed assets created on or after 1 April 2002 when the Schedule came into force, or (if created earlier) transferred between unrelated parties on or after that date. Thus assets created before 1 April 2002 and transferred between "related parties" on or after this date are normally excluded.

22. The "market value" rules ensure that, in many circumstances, transfers of intangible assets between related parties are deemed to take place at market value rather than the price agreed between the parties. This applies for all purposes of "the Taxes Acts" (as defined in paragraph 142 of Schedule 29) as regards both the transferor and the transferee. The purpose of these rules is to prevent related parties from gaining a tax advantage by agreeing an artificially high or low price for an intangible asset.

23. The single payment scheme was introduced by Council Regulation (EC) No 1782/2003. It is a system of support payments for farmers under the EU Common Agricultural Policy. Payment entitlements under the single payment scheme were added to the list of qualifying assets in section 155 of TCGA 1992 by The Finance Act 1993, Section 86(2), (Single Payment Scheme) Order 2005, SI 2005/409 with effect from 22 March 2005.

CLAUSE 42 AND SCHEDULE 9: INSURANCE COMPANIES ETC.

SUMMARY

1. Clause 42 and Schedule 9 counter avoidance of corporation tax by companies carrying on life assurance business where there is a transfer of insurance business. They also provide for a regulation making power to amend the apportionment rules applying to life insurance companies in general and amend the rules for determining which funds are recognised for tax purposes; and make some technical amendments to legislation about insurance companies as a result of changes made by the Financial Services Authority to its Handbook.

DETAILS OF THE CLAUSE

2. Clause 42 introduces Schedule 9.

DETAILS OF THE SCHEDULE

3. The Schedule introduces amendments to various provisions in the order in which they appear in the Tax Acts. For the purposes of this note the paragraphs are considered by theme.

Regulatory Reform – 2004 changes

Section 76 Income & Corporation Taxes Act 1988 (ICTA)

4. Paragraph 1 provides an amendment to section 76 ICTA (expenses of companies carrying on life assurance business).

5. Section 76(8) of that Act provides that an attribution of expenses of a life assurance company to basic life assurance and general annuity business (BLAGAB) has to be made under what the statute calls "proper internal accounting practice". The subsection provides that in deciding what is such practice, regard must be had both to generally accepted accounting practice and to the Interim Prudential Sourcebook (Insurers) - IPRU(INS) - which is the sourcebook currently applying to insurers.

6. However, the Financial Services Authority (FSA) has made an instrument (the Integrated Prudential Sourcebook (Insurers and Other Amendments) Instrument 2004 (FSA 2004/87)) enacting parts of its Integrated Prudential Sourcebook ("PRU") applying to insurers. This has effect on 31 December 2004 and therefore applies to a company's periodical return to the FSA ending on that date.

7. Accordingly, paragraph 1(2) inserts a reference to the Integrated Prudential Sourcebook in section 76(8) ICTA.

Sections 431 and 432A ICTA

8. Paragraph 2 amends section 431(2) ICTA. That subsection is an interpretation provision for all legislation applying to insurance companies including Part 1 of Chapter 12 ICTA, sections 82 to 90 Finance Act ("FA") 1989 and certain provisions of the Taxation of Chargeable Gains Act 1992 ("TCGA").

9. Paragraph 2(2) inserts a definition of the Integrated Prudential Sourcebook.

10. Paragraph 2(3) changes the definition of "liabilities". The Integrated Prudential Sourcebook includes new rules that must be followed by companies writing a substantial amount of with-profits business in calculating their capital requirements. They must calculate the value of their assets and liabilities (and so the margin of difference) not only in accordance with the existing regulatory rules based on the EC Consolidated Life Insurance Directive but also using what is known as "realistic" reserving. The company's capital requirement is based on the higher of the two figures (the so called "twin peaks" approach).

11. The calculation of liabilities relating to insurance business, under the realistic approach, is very different from the calculation under the existing "regulatory" approach. And the calculation of the regulatory liabilities for those companies also differs somewhat from the existing basis, which will continue to be used by non-twin peaks companies.

12. Since the regulatory liabilities will be the ones used in all cases for determining surplus and in the interests of having a consistent approach as far possible to all companies, those liabilities will continue to be the ones which are used for tax purposes.

13. Accordingly, paragraph 2(3) now defines liabilities to mean the mathematical reserves of the company determined in accordance with Chapter 7.3 of PRU. "Mathematical reserves" is the term continuing to be used in PRU for the regulatory calculation of liabilities.

14. The new definition of "liabilities" also includes deposit-back arrangements where the value falls to be determined in accordance with Chapter 1.3 of PRU.

15. In the existing definition of "liabilities" there is a mention of "long-term liabilities" which is then separately defined. There is now no need for a separate definition of "long-term liabilities" as by referring to "mathematical reserves" it follows automatically that the liabilities concerned are long-term liabilities. Thus paragraph 2(4) omits the definition of "long-term liabilities".

16. Paragraph 4 as a consequence of that omission changes the references from "long-term liabilities" to "liabilities" in section 432A(9A) ICTA, which relates to the exclusion of the overseas life assurance fund in certain calculations of apportionment of income and gains.

17. Paragraph 2(5) makes a corresponding change to the definition of "value". The valuation of asset rules in the IPRU(INS) are moved to PRU and so the reference now is to Chapter 1.3 of PRU, read with Chapter 3.2 which sets out certain deductions from the Chapter 1.3 value for counterparty risk etc.

Section 444BA ICTA

18. Paragraph 9 makes another consequential amendment, this time to section 444BA ICTA which relates to equalisation reserves for general insurance business. That legislation depends substantially on figures in the equalisation reserves of a company calculated in accordance with "Equalisation Reserves Rules", currently in Chapter 6 of IPRU(INS). Paragraph 9(2) changes the reference to Chapter 6 to become one to Chapter 7.5 of PRU where the new Equalisation Reserve Rules are to be found. An equivalent change to regulation 2 of the Insurance Companies (Reserves) (Tax) Regulations 1996 was made by a Statutory Instrument, the Insurance Companies (Reserves) (Tax) (Amendment) Regulations 2004 (SI 2004/3260) laid on 10 December 2004.

Section 82B Finance Act 1989

19. Paragraph 10 amends section 82B FA 1989. That section deals with those few companies which write with-profits business but which do not elect under the current Rule 4.1(6) IPRU(INS) to attribute a value to their assets which is lower than market value in order to create a "reserve" to meet in particular future terminal bonus payments. Instead such companies keep an amount in their unappropriated surplus to meet those eventualities.

20. One of the conditions of the operation of section 82B FA 1989 is that the company does not make the book value election in accordance with Rule 4.1(6). Chapter 4 of IPRU(INS) is being deleted as a result of the inclusion in PRU of the Asset Valuation Rules previously in Chapter 4. But Rule 4.1(6) is not being reproduced in PRU and is moving to Chapter 9 of IPRU(INS), the Accounts and Statements Rules, where it becomes Rule 9.10(c). Paragraph 10(2) makes the necessary change.

Section 431A ICTA

21. Paragraph 3 amends the regulatory making power in section 431A ICTA. It substitutes a new section 431A.

22. New subsection (1) reproduces the old section 431A ICTA allowing amendments to be made by order to any insurance company taxation provision whenever the FSA changes its legislation. An order under the existing version of section 431A was laid on 10 December 2004 – the Insurance Companies (Corporation Tax Acts) Order 2004 (SI 2004/3266).

23. New subsection (2) provides that any amendments to be made under subsection (1) (FSA changes) to the tax provisions relating to insurance companies to have effect for a period which is the period for which the relevant FSA changes also have effect.

24. New subsection (3) provides that the Treasury may amend a number of life assurance company tax provisions relating to apportionment of income and gains. Those provisions are

    - section 432ZA ICTA (apportionment of income & gains from linked assets)

    - section 432A ICTA (apportionment of income & gains of long-term insurance fund generally)

- sections 432B to 432G ICTA (apportionment of investment return etc. in cases where profits charged under Case VI of Schedule D)
- section 755A ICTA (controlled foreign company apportionments)
- Schedule 19AA ICTA (overseas life assurance fund)
- sections 83A FA 1989 (recognition of accounts for section 432B to 432F ICTA purposes)
- section 85 FA 1989 (apportionment of miscellaneous receipts)
- sections 88 and 89 FA 1989 (allocation between policy holders and shareholders of profits and income)
- section 210A TCGA (ring fencing of policy holders' chargeable gains).

25. It is proposed that this power be used to enact the changes to the apportionment rules foreshadowed in the announcement at Pre-Budget Report ("PBR") on 2 December 2004. Namely that regulations would be made to ensure a more appropriate tax treatment of income and gains on assets of a company's "inherited estate" (its free assets not required to meet policy holders' liabilities and other requirements).

26. New subsection (4) provides that the new power in subsection (3) must only have effect for periods of account beginning on or after 1 January 2005 and ending before 1 October 2006. But new subsection (5) allows this date to be extended by Treasury order to 1 January 2007.

27. New subsection (6) is a standard provision for regulation-making powers allowing the order to make different provision for different cases, and any consequential and transitional provision that are necessary, especially where the power in new subsection (3) is used.

28. Because a number of the changes being made by this Schedule have effect for periods of account ending on 31 December 2004, and so will primarily affect periodical returns covering the 2004 calendar year, it has not been possible to use section 431A to make those amendments.

29. New subsection (7) defines "insurance company taxation provision" in similar terms to the current section 431A.

Section 156 FA 2003

30. Paragraph 17 amends section 156 FA 2003. That section deals with the changes to the regime for overseas life insurance companies that were necessary when the corporation tax treatment of non-residents trading in the UK was substantially amended by sections 148 to 155 FA 2003. Subsection (4) allowed regulations to be made modifying the overseas life insurance company legislation but only "in year" where the changes were needed as a result of other changes made by FA 2003. To bring these rules into line with the new section 431A ICTA, paragraph 17(2) substitutes a new subsection (4) which allows regulations to have effect in year.

Commencement

31. All the changes except those to section 431A ICTA and section 156 FA 2003 described above have effect in relation to periods of account ending on or after 31 December 2004. The changes to section 431A and section 156 will have effect from Royal Assent as until then regulations cannot be made using the extended powers.

Transfers of Business

32. Schedule 33 FA 2003 and Schedule 7 FA 2004 made a number of changes to the tax treatment of transfers of insurance business primarily to close loopholes and to block attempts to exclude profits from tax or to prevent profits which would emerge in the normal course of events after the transfer from ever emerging at all. Despite these measures companies have continued to look for ways to achieve this result without falling foul of the existing law. The changes made by paragraphs 5, 6, 7, 8 and 11 of the Schedule will, among other things, stop three more ways that have been found to exploit the rules.

Transfers of business: deemed periodical return

33. Paragraph 6 amends section 444AA ICTA. Sub-paragraph (2) inserts a new section 444AA(7). This section deals with the case where a company ceases to carry on long-term business as a result of a transfer of the whole of that business, but continues to carry on

other insurance business. References in section 444AA to a company's "last period" are modified (by section 444AA(7)(a)) in this case to mean the last period for which a periodical (FSA) return contains long-term business entries. Section 444AA(7)(b) also preserves the effect of an actual return which is otherwise ignored but only for the purposes of sections 444BA to 444BD (equalisation reserves of general insurers) as they are based on the figures in the FSA return.

34. Sub-paragraph (3) provides that the new rule has effect in relation to transfers on or after 30 June 2005.

Transfers with Excess Liabilities

35. Paragraph 7 amends section 444AC ICTA. That section currently provides a relief from tax in a case where a company transfers more assets than liabilities and where the excess represents surplus that has already been brought into charge to tax in the hands of the transferor. When that section was originally exposed in draft in 2003 it included a further provision which provided that in the opposite case where the liabilities transferred exceeded the assets a charge to tax would arise on the difference. Representations were made at the time that this rule was unnecessary having regard to some of the other changes being made in FA 2003 and that it would not be possible to use this type of transfer to avoid tax. Accordingly, the relevant provision was deleted from the Finance Bill 2003. However, it has become clear that those assurances were over-optimistic. HM Revenue and Customs has seen transactions where there has been a transfer of excess liabilities designed to exclude profits from tax and which are not caught by any other provisions of the life assurance taxes provisions.

36. Accordingly, the rule omitted from Finance Bill 2003 is reinstated by paragraph 7(3) as section 444AC(2A) to (2E) ICTA. New section 444AC(2A) sets out the case: where the liabilities to policyholders and annuitants transferred, together with any relevant debts, exceed the "element of the transferee's line 31 figure representing the transferor's long-term insurance fund". This expression means the figure included in line 31 of Form 40 (the revenue account in the FSA return).

37. New section 444AC(2B)(a) ICTA then provides that the excess is to be treated as a trading receipt of the transferee's life assurance business for Case I purposes for the period of account of the transfer; and new section 444AC(2B)(b) that the relevant

proportion of the excess is to be treated as a receipt of any category of business. The relevant proportion is the proportion that the category of liabilities included in the transfer bears to the total liabilities transferred.

38. New subsections (2C) and (2D) deal with exceptions from the charge under section 444AC(2B). The exceptions apply where the excess liabilities transferred are disallowed for the purposes of the Corporation Tax Acts in computing the company's Case I profit (subsection (2C)) or its Case VI profit from any category of business (subsection (2D)) and, where the liabilities disallowed are liabilities at the end of the period of transfer, there is a condition that the opening liabilities of the next period have not been adjusted.

39. New section 444AC(2E) defines "transferred liabilities" in the previous two subsections to mean either liabilities shown at the end of the period of account of the transferee in which the transfer takes place, or amounts actually paid to discharge such liabilities by way of payment of claims.

40. This provision differs from that originally drafted for the Finance Bill 2003 in that it includes "relevant debts" as well as liabilities to policyholders and annuitants. Paragraph 7(4) inserts new subsections (4) to (11) into section 444AC. New subsection (4) defines relevant debts to mean debts which become debts of the transferee's long-term insurance fund as a result of the transfer. This therefore includes any transfer of liabilities which are not insurance liabilities such as bank borrowings.

41. New subsection (5) qualifies the meaning of relevant debts by limiting the amount to be taken into account. The case is where

    - the fair value, as at the date of the transfer, of the assets which become assets of the transferee's long-term insurance fund as a result of the transfer

    exceeds

    - the amount of the transferor's long-term insurance fund (which excludes relevant debts) transferred.

    If this is the case, the amount of any relevant debts is reduced by the excess.

42. New subsection (6) glosses "transferred liabilities" as used in subsection (2B). In arriving at the figure any financial reinsurance associated with the transferred liabilities is disregarded so that they are not reduced by such reinsurance. This is necessary because, among other reasons, the definition of "liabilities" inserted into section 431(2) ICTA by paragraph 2 of the Schedule automatically sets off reinsurance (see Rule 7.3.29(4) and sections 7.3.79 to 7.3.92 of the PRU).

43. But this subsection is also qualified in the case given by new subsection (7). That case is where the reduction in liabilities mentioned in subsection (6) results from reinsurance under a contract which was entered into by the transferor as cedant before the date of the transfer and it is one under which the transferor's rights and obligations are transferred to the transferee.

44. In that case the amount of the reduction of liabilities potentially disregarded under subsection (6) is reduced. The amount of the reduction is the lesser of two calculations, that given by new subsection (8) and that given by new subsection (9).

45. The calculation given in section 444AC(8) ICTA is of the amount by which the liabilities taken into account in computing the Case I profits of the transferor's business for the closing period were reduced as a result of the reinsurance.

46. The calculation given in section 444AC(9) ICTA is of the "reduction amount" or the aggregate of those amounts for the "reduction period" or for each such period. In the subsection "reduction amount" means the amount by which the Case I profits of the transferor's business were increased or the losses reduced for the reduction period as a result of reinsurance under the contract.

47. New section 444AC(10) ICTA defines "closing period" to mean, where part only of the business is transferred by the transferor, the accounting period of the transferor ending with the transfer, or if the case is one of a whole business transfer, the accounting period ending immediately before the transfer.

48. It also defines "transferor's business" as used in section 444AC(8) to mean either its life assurance business as a whole or a category of business, depending on whether section 444AC(2C) or (2D) applies.

49. Finally, new section 444AC(11) ICTA contains a definition of "insurance business transfer scheme" using the extended definition currently appearing in section 444AA(6) and section 82C(9) FA 1989. The extended definition covers transfers of business which is carried on outside the European Economic Area ("EEA"). The normal definition of "insurance business transfer scheme" given by section 431(2) ICTA only covers transfers falling within Part 7 of the Financial Services and Markets Act 2000 which requires the business transfer to be carried on in an EEA state.

50. New section 444AC(11) also defines "fair value" to have its section 441B(6) ICTA meaning.

51. Paragraph 7(2) also inserts a reference to relevant debts into section 444AC(2) ICTA to bring the calculation there into line with that in section 444AC(2A). Relevant debts are already taken into account in section 444AB where they are included in "the retained liabilities" and in section 82C(5) FA 1989 which also deals with the deficiency of assets where there is a financial reinsurance (but see notes on paragraph 11 of the Schedule in paragraph 54 below).

52. Paragraph 7(6) provides the commencement rule for the changes to section 444AC. They apply to where there is an insurance business transfer scheme taking place on or after 2 December 2004 (the date of the PBR).

53. Paragraph 7(5) amends the heading to reflect the new scope of the section. Paragraph 7(7) is an ephemeral rule – it provides that in relation to a transfer between 2 December 2004 and the start of a company's use of the revised FSA return, "line 31" in section 444AC(2A)(b) is to be read as "line 15".

Consequential amendments to section 82C FA 1989.

54. Paragraph 11 amends section 82C FA 1989 which concerns financial reinsurance contracts. Section 82C operates where either of two conditions is met. One of those conditions, condition B, applies where there is a transfer of business with a deficiency of assets. This case is now covered by section 444AC(2A) ICTA (see paragraph 36 above), so it is no longer necessary to include condition B. Paragraph 11(2) amends section 82C(1) to delete the reference to condition B and paragraph 11(3) omits subsections (4), (5), (8) and (9) which are the subsections dealing with condition B.

55. These amendments have effect where there is an insurance business transfer scheme within the extended meaning, that given by section 82C(9) FA 1989, which takes place on or after 2 December 2004.

56. Where there was a transfer of business before that date to which condition B applied the provisions of section 82C dealing with the recapture of liabilities and the charge to tax arising in subsequent periods will continue to apply.

Case where shares in the transferor are assets of the transferee's long-term insurance fund.

57. Paragraph 8 inserts a new section 444ACA into ICTA.

58. In an insurance business transfer scheme it is usually the case that the assets of the transferor are transferred to the transferee in consideration only of the transferee assuming the liabilities of the transferor. Thus where the transferor has an excess of assets (including the value of in-force business) over liabilities as a result of the transfer, the value of the shares will fall by roughly the amount of the excess.

59. Where the provisions of TCGA apply to this transaction (i.e. where the assets are such that gains fall within BLAGAB income and gains), such a transfer would be regarded as a depreciatory transaction falling within section 176 TCGA. An adjustment would then be made to the amount of any allowable loss arising. This is what will happen so far as any loss on the shares is attributable to the company's BLAGAB. But where the shares and the transactions in them are referable to other categories of business, and also in computing the profits of the life assurance business in accordance with the rules of Case I of Schedule D, the rules dealing with a reduction in the value of shares for Case I purposes may not cover this case. It is possible that in certain cases the provisions of section 703 to 709 ICTA (see head B of section 704) may apply, as may section 736 ICTA.

60. But section 444ACA ICTA will apply in any case where section 703 does not apply and will apply in priority to section 736. What it does is to treat an amount equal to the reduction in fair value of the shares as a receipt of the transferee for the purposes of section 83(2) FA 1989 in the period of account in which the transfer takes place.

61. New subsection (1) provides for the case where there is an insurance business transfer scheme (within the extended definition given by section 444AC(5) ICTA).

62. New subsection (2) is the operative rule. The section operates where the transferor is a company whose shares are assets of the long-term insurance fund of the transferee and where as a result of the transfer, the fair value of those shares is reduced. It will also apply where the shares in the transferor are held indirectly, so that the asset of the fund whose value is reduced by the transfer is shares in an intermediate company – see definition of "relevant shares" in new section 444ACA(4).

63. But this rule is qualified in certain circumstances. These are where

- the assets transferred are or include assets which, immediately before the transfer were assets of the transferor, but not assets of the transferor's long term insurance fund

and

- an amount is brought into account by the transferee in respect of the relevant assets as other income in the period of account in which the transfer takes place, and is taken into account in computing the profits of the transferee's life assurance business and any category of its life assurance business.

If this is the case, then the section 444ACA(2) amount is reduced the amount so taken into account.

64. New subsection (4) defines "fair value" by reference to the meaning given in section 444AB(6), which is the amount which would be obtained from an independent person purchasing the assets or, if the assets are money, the amount.

65. New subsection (5) provides that "shares" includes any interests in the company possessed by members of the company. Thus it includes the rights of a member of a mutual insurer.

66. Section 444ACA ICTA applies in relation to insurance business transfer schemes within the extended definition taking place on or after 2 December 2004.

67. Paragraph 5 makes consequential adjustments to section 432E(2A) ICTA. Because section 444ACA amounts do not feature in any

revenue accounts of the company, it is necessary to add them to the section 83(2) FA 1989 net amount to be apportioned under section 432E(2) ICTA, in the same way as amounts falling within section 83(2B) FA 1989. Paragraph 5(2) and (3) makes the necessary changes, and paragraph 5(4) gives the changes the same commencement rules as section 444ACA ICTA.

Transfers of business: accounting periods

68. Paragraph 20 makes some minor technical changes to the rules about accounting periods where there is a transfer of business.

69. Paragraph 20(3) inserts a new section 12(7C) into ICTA. Paragraph 12(7A) ICTA (which is made subject to section 12(7C) by an amendment made by paragraph 20(2)) provides that an accounting period of an insurance company will always end with a transfer of business. This means that it ends immediately after the transfer.

70. Section 444AA ICTA gives rules for determining when there is a period of account in cases where there is a transfer of the whole of the business of an insurance company. A period of account will end immediately before the transfer even if the regulatory return is not drawn up to that time (section 444AA(2) ICTA) as well as in the case where it is. In all “whole business transfer” cases a period of account will be treated as covering the time of the transfer – section 444AA(3) ICTA.

71. As a result of section 444AA(3) ICTA it follows that there is an accounting period covering the time of the transfer in cases where there was actual period of account ending immediately before the transfer. But it is less clear that that is the effect in the case of a notional section 444AA(2) ICTA return.

72. Section 12(7C) ICTA therefore makes it clear that an accounting period ends when a period of account ends immediately before the transfer, and that there is an accounting period covering the time of the transfer. This applies only in whole business transfer cases.

73. Paragraph 20(4) to (6) makes consequential amendments to sections 444AB and 444ABA ICTA, and to section 213 TCGA, to clarify which accounting period is meant in those cases.

74. Paragraph 20(7) gives the general commencement rule for all parts of the paragraph apart from sub-paragraph (6). The general rule

applies in relation to transfer schemes taking place on or after 16 March 2005. For sub-paragraph (6), paragraph 20(8) applies what is a relieving provision from 1 January 2003, when the relevant amendments to section 213 TCGA have effect.

"Notional" income

75. Paragraph 12 modifies section 83(2A) FA 1989. That subsection includes three exemptions from the rule in section 83(2) that all amounts shown in lines 12 to 15 of Form 40 are automatically to be brought into account as receipts for tax purposes. One of the exceptions is for "notional income".

76. HM Revenue and Customs has become aware that some companies may be seeking to argue that amounts brought into account in those lines constitute notional income, even though there is nothing notional about them. The argument is based on the definition of "notional income" in section 83(2A)(a) FA 1989. HM Revenue and Customs does not accept that the definition is such that amounts that are not truly notional can be treated as notional income. But for the avoidance of doubt having regard to the amounts of money that may be involved section 83(2A)(a) is being amended. Paragraph 12(2) provides that the existing paragraph (a) is divided into two. There is a new paragraph (a) referring to notional income as defined in the new section 83(2AA) and a separate exclusion in new paragraph (aa) for inter-fund transfers.

77. Paragraph 12(3) inserts a new section 83(2AA) into FA 1989 to define notional income more precisely. Income is only to be regarded as notional income if it represents income which has not in fact been received or is not receivable from another person and where a corresponding notional expense of the same amount is also brought into account. This rule therefore continues to exempt the kind of notional income for which section 83(2A)(a) FA 1989 was designed, such as notional rents on land held by the company. The broad intention is that "notional income" should encompass only amounts created as a result of a book-keeping entry in the regulatory return that creates a corresponding entry for a notional expense.

78. Subsection (2AA) goes on to provide that a notional expense may only be used once in determining whether corresponding income arises.

79. New section 83(2AB) FA 1989 defines "notional expense" to mean an expense which has neither been paid nor is payable to another person and which is not deductible in computing the profits of the company under Case I, because it is notional, but would have been deductible if it had actually been paid. So a notional rent payment would fall within this definition because, had it actually been paid to another person, it would have been a deductible expense under Case I.

80. New section 83(2AC) FA 1989 ensures that where amounts are netted off in line 15 of Form 40 only the net amount is excluded from the charge under section 83(2). New section 83(2AD) defines an inter-fund transfer as one between two funds of the company which is shown in, or included in, line 14 of Form 58 in one fund's return and in line 33 of Form 58 in the other's. Form 58 is the regulatory form dealing with the valuation results and distribution of surplus.

81. These changes have effect in relation to periods of account ending on or after 2 December 2004.

Expenses in Line 12

82. Paragraph 12(4) amends section 83(2B) FA 1989. This requires payments out of a long-term fund to be brought into account as a Case I receipt, except where they are part of total expenditure in the revenue account (Form 40). But some expenses are brought into account in the revenue account, not as total expenditure, but by being netted off against investment income. The new second sentence of section 83(2B) inserted by paragraph 12(4) also excludes these expenses.

83. Paragraph 12(6) provides that the new rule has effect in relation to periods of account beginning on or after 1 January 2005 (as it is relieving).

Recognised Funds – Section 83A FA 1989

84. Paragraph 13 of the Schedule amends section 83A FA 1989.

85. Paragraph 13(2) provides that apart from the revenue account for the whole business (section 83A(2)(a) FA 1989) there is only otherwise recognised a "with-profits fund". Paragraph 13(5) inserts a new section 83A(6) into FA 1989 which shows that "with-profits fund" has the meaning it has in PRU, namely—

(a) a long-term insurance fund (or that part of such a fund) in which policy holders are eligible to participate in any established surplus; and

(b) where it is an insurer's usual practice to restrict policyholders' participation in any established surplus to that arising from only a part of the fund (or part fund) falling within (a), that part (or that part of the part fund).

Section 83A(6) FA 1989 also defines "non-profit fund" in terms of the PRU meaning (see notes on section 83A(3B) FA 1989).

86. Paragraph 13(3) gives a new rule in new section 83A(3A) FA 1989 for the case where a with-profits fund for which a Form 40 is required to be prepared is included as part of another with-profits fund – called the "wider fund". The general rule to this effect is in section 83A(3A)(a) FA 1989. Section 83A(3A)(b) FA 1989 has the effect that the rule will only apply in the case of a mutual insurer where the with-profits funds are 100:0 funds - see next paragraph. Section 83A(3A)(c) FA 1989 deals with further nesting of with-profits funds. In any such case the wider fund is not looked at for the purposes of sections 82A to 83AB FA 1989.

87. New section 83A(3B) FA 1989 provides that if there is, in the case of a mutual, a with-profits fund that is not a 100:0 fund, then the with-profits fund is not recognised, with the result that the wider fund is recognised. Section 83A(3C) FA 1989 defines a "100:0" fund as a fund in which the only people with any entitlement to its profits are the policyholders of that fund.

88. New section 83A(3D) and (3E) FA 1989 deals with the case where a non-profit fund is included in a with-profits fund and separately accounted for. In that case, the account for the with-profits fund does not include the non-profit fund elements. Those elements will be included as, or in, the section 83A(4) FA 1989 balance fund.

89. Paragraph 13(4) substitutes a new section 83A(4) FA 1989 dealing with the residue of funds. Where there are with-profits funds that together do not account for the whole long-term insurance fund, any balance, being a non-profit fund or funds, will make up the residual fund without any division where there is more than one fund. Note that in the normal case of a non-recognised wider fund where all the "sub-funds" are with-profits, there is no residue, but the wider find is still ignored.

90. Paragraph 13(6) gives the commencement rule – it is periods of account beginning on after 1 January 2005.

91. Paragraph 14 provides a transitional rule where the make up of recognised funds changes from one period to the next (the "new period"). Paragraph 14(1) does this by inserting a new section 83B into FA 1989. Where this happens, the section 432F(2) ICTA excesses carried forward at the end of the earlier period are allocated to the new recognised funds in an appropriate manner.

92. Paragraph 14(2) gives the commencement rule – it applies to new periods of account beginning on after 1 January 2005.

Charge of certain receipts: section 85 FA 1989

93. Paragraph 15 amends section 85 FA 1989 (charge to tax under Case VI on miscellaneous receipts referable to BLAGAB).

94. Paragraph 15(2) inserts a new section 85(2)(f) FA 1989 containing an exemption from tax for receipts from the Financial Services Compensation Scheme ("FSCS"). If the FSCS is required to compensate policyholders of an insurance company, it may either pay compensation to them directly or to the insurance company so that the company can increase the benefits due. In the former case there is no tax effect on the insurer, and the policyholder pays any appropriate tax on the compensation. In the latter case, the payments to the policyholder are not deductible in an I minus E computation, but section 85 FA 1989 would have the effect of taxing the receipt. The exception made here removes that mismatch.

95. Paragraph 15(3) corrects a minor error made when section 85 FA 1989 was amended by Schedule 7 FA 2004. Paragraph 6 of that Schedule inserted specific apportionment rules into section 85, and did so for refunds of acquisition expenses. But it did not lay down any rule for attributing refunds of other expenses. Paragraph 15(3) inserts a new section 85(2C)(aa) into FA 1989 which attributes such refunds to BLAGAB if the expenses were deductible under section 76 ICTA (which requires the amounts to be referable to BLAGAB).

96. Paragraph 15(4) gives the commencement rule, which is that the changes have effect in relation to accounting periods ending on or after 16 March 2005.

Corporation tax: policy holders' fraction of profits

97. Paragraph 16 amends section 88 FA 1989. This section defines "relevant profits" for the purposes of determining how much of a life insurance company's profits are taxed at the "policyholders' rate" of corporation tax. In FA 2004, the definition of "BLAGAB income and gains" in subsection (3A) of section 88 was amended to show that the income and gains were those apportioned to BLAGAB under section 432A ICTA. This followed the generalisation of section 432A as an apportionment rule applying in every case, and not just where there was more than one category of business.

98. But there are some types of income which are referable to BLAGAB, yet not as a result of section 432A. These types do not then fall to be treated as relevant profits and cannot benefit from the policyholders' rate.

99. Paragraph 16(2) cures this fault by inserting in subsection (3A) further categories of income which are included in relevant profits. They are-

- amounts chargeable under section 85 FA 1989 (miscellaneous receipts) – new section 88(3A)(aa) FA 1989
- amounts charged under section 441B(2) ICTA (land in UK linked to OLAB) - new section 88(3A)(ab)
- amounts charged under section 442A ICTA (reinsurance) – new section 88(3A)(ac)

Paragraph 16(3) gives the commencement – periods of account beginning on or after 1 January 2005 (as the change is relieving).

Meaning of "pension business"

100. Paragraph 18 amends the new definition of pension business in section 431B ICTA substituted by paragraph 20 Schedule 35 FA 2004 with effect from "A-day" – 6 April 2006.

101. Paragraph 18(3) amends section 431B(2) ICTA which deals with the effect of deregistration of a pension scheme. The amendment ensures that it is only forced deregistration where HM Revenue and Customs takes action that is relevant. This means that where a scheme is wound up for example, but an insurance company

continues to pay annuities, the business of paying the annuities remains pension business.

102. Paragraph 18(4) adds a new section 431B(3) into ICTA. This deals with transitional cases, where annuities in payment are pension business under the current section 431B(2) on A-day, but do not become part of a registered pension scheme on A-day. They remain referable to pension business.

103. Paragraph 18(6) makes a corresponding amendment to that made by paragraph 18(3) in section 466(2B) ICTA defining the pension business of friendly societies.

104. Paragraph 18(7) gives A-day as the commencement day.

Miscellaneous references to "class" of business

105. Paragraph 19 changes the word class to category in a number of places in the life assurance tax provisions. "Class" is the term used in regulatory legislation, whereas "category" refers to the types of business where tax rules make a distinction. In the provisions below, "class" was used where "category" is the better term.

106. The change is made by paragraph 19(1) to (4) in-

- section 432B(1) ICTA (apportionment of receipts brought into account)
- section 444A(3) ICTA (transfers of business)
- paragraph 19 Schedule 12 FA 1997 (leasing arrangements: finance leases and loans)
- paragraph 138 Schedule 29 FA 2002 (interpretation provisions relating to insurance companies' gains and losses from intangible fixed assets).

107. These amendments have effect in relation to periods of account beginning on or after 1 January 2005 – paragraph 19(5).

BACKGROUND NOTES

Regulatory change

108. The tax computations of life insurance companies are closely linked to the regulatory returns they make to the FSA. The regulatory accounting rules, and hence the detailed content of the returns, are undergoing a significant programme of change. This requires consequential changes to the corresponding provisions in the Taxes Acts. Although some of these changes can be made by regulations, some – especially those affecting past accounting periods – cannot.

Apportionment of income and gains

109. Because different categories of a life company's business are taxed in different ways, it is necessary to attribute income and gains specifically to those categories. Although income and gains in respect of linked business can be attributed factually, the majority of income and gains arise on unlinked business in respect of which no factual attribution can be made. The Taxes Acts provide detailed apportionment rules to deal with this issue. The apportionment rules have not given satisfactory results in two particular circumstances.

110. The first of these is where the company has several subfunds. The rules provide that, for certain purposes, the apportionment rules apply separately to some or all of these subfunds rather than to the business as a whole. There has been uncertainty about which of these subfunds should be treated separately and some companies have sought to gain a tax benefit by creating additional subfunds and seeking to recognise them for separate apportionments. Schedule 9 clarifies the circumstances in which a subfund will qualify for a separate apportionment, in general recognising only with-profits subfunds and a single subfund comprising the rest of the company's business.

111. The second circumstance is where the company holds more assets than are realistically needed to meet obligations to policyholders. The apportionment rules have tended to apportion some of the income and gains on these assets to the policyholders' parts of the life company's business where they have been exempted from corporation tax as referable to pension business even though they

have no connection with that business, or subjected to special policyholders' tax rates that are lower than normal rates of corporation tax. Schedule 9 provides authority for regulations to improve the apportionment rules after consultation with industry representatives.

Transfers of business

112. Schedule 33 FA 2003 and Schedule 7 FA 2004 made a number of changes to the tax treatment of transfers of insurance business primarily to close loopholes and to block attempts to exclude profits from tax or to prevent profits which would emerge in the normal course of events after the transfer from ever emerging at all. Despite these measures companies have continued to look for ways to achieve this result without falling foul of the existing law. The changes made by paragraphs 5, 6, 7, 8 and 11 of the Schedule will, among other things, stop three more ways that have been found to exploit the rules.

113. One of these measures deals with transfers of business where the transferred liabilities exceed the transferred assets. Such arrangements can be coupled with other arrangements such as financial reinsurance in order to prevent the deficiency of assets from damaging the company's solvency. The complexity of the changes to section 444AC ICTA 1988 is largely because of the need to deal with such involved arrangements.

114. Another modifies the references in section 444AA ICTA to a company's "last period". The third measure deals with transfers where the transferor is owned by the transferee and the resulting diminution in the value of the transferor is argued to reduce the transferee's profit, thereby giving relief for the cost of the business being bought.

Notional income and inter-fund transfers

115. In general whatever income a company brings into the revenue account in its regulatory return is a trading receipt for corporation tax purposes. However, companies sometimes include "notional" amounts in their revenue accounts that ought not to be treated as trading receipts. A typical example is where the long-term fund owns the company's head office building and central overheads include a rent that is credited to the particular subfund that owns the building. It is not appropriate to treat the rent as either taxable

income or an allowable expense. A rule intended to have this effect was introduced in FA 2003 but evidence came to light that a company was seeking to exploit ambiguity in the wording of that rule. The rule is therefore being clarified and, at the same time, the treatment of transfers from one subfund to another is being made explicit.

Financial Services Compensation Scheme

116. Where basic life assurance and general annuity business is taxed on the I minus E basis, the taxable profits are the income plus gains less management expenses. The income excludes premiums but includes investment income and any items other than premiums that would be treated as trading receipts in a computation of trading profits. This would include amounts payable under the Financial Services Compensation Scheme, which would be a disincentive to making compensation through a company rather than direct to a policyholder. To remove this disincentive, such payments are being excluded from the measure of income in the I minus E computation.

EXPLANATORY NOTE

CLAUSE 43: IMPLEMENTATION OF THE AMENDED PARENT/SUBSIDIARY DIRECTIVE

SUMMARY

1. Clause 43 amends the minimum holding test in section 801 ICTA so that it meets the requirements of the amended Parent Subsidiary Directive (PSD).

2. Underlying tax credit relief provided by Double Taxation Agreements (DTAs) applies only to tax paid in one or other of the countries party to the DTA. It does not include taxes paid in third countries or underlying tax paid by companies which have themselves paid dividends to the first tier foreign company. Accordingly, the basic relief provided under DTAs is extended by section 801.

DETAILS OF THE CLAUSE

3. Subsection (1) amends section 801 ICTA.

4. Subsection (2) introduces a new subsection 5A into section 801 which ensures that the section now complies with the revised PSD in relation to the ownership requirement for lower tier subsidiaries. It does this by providing that the test be by reference to ordinary share capital rather than voting power.

5. Subsection (3) provides that the amendment has effect where the relevant foreign dividend is paid on or after 1 January 2005.

BACKGROUND NOTES

6. The amended PSD came into effect on 1 January. The UK already gives effect to the main thrust of the changes in its double taxation relief legislation but a small technical change is required in order to bring the legislation fully into line with the PSD. This change will allow for the minimum holding test to be satisfied by the size of the capital holding rather than voting rights in particular circumstances. Although it is expected to have little impact it is needed to comply with the terms of the PSD.

EXPLANATORY NOTE

CLAUSE 44: TERRITORIES WITH A LOWER LEVEL OF TAXATION: REDUCTION OF AMOUNT OF LOCAL TAX

SUMMARY

1. Clause 44 protects the UK tax base by closing a loophole in the Controlled Foreign Company "CFC" rules that are designed to prevent UK multinationals from diverting profits to low tax regimes. These rules makes a comparison between the tax paid by the subsidiary and the tax that would have been payable if the subsidiary was subject to UK tax. Some groups have arranged for a significant amount of income to arise in a subsidiary, which is not subject to tax under UK rules but distorts the application of the low tax measure. This clause amends the operation of the lower level of taxation test to prevent this distortion. The clause also reduces the measure of tax paid locally where that tax has been repaid to another person.

DETAILS OF THE CLAUSE

2. Subsection (1) introduces the clause and refers to section 750.

3. Subsection (2) adds a new clause requiring that a new subsection (1A), must be taken into account before making the tax comparison provided by section 750(1).

4. Subsection (3) introduces the new subsection (1A) to section 750 of ICTA1988, which reduces the amount of local tax used in the comparison. It identifies income or expenditure of the subsidiary which has been taken into account in determining the tax paid locally but which would not have been taken into account in arriving at tax due under the UK rules as applied to CFC.

5. Subsection (3) also introduces new subsection (1B) to section 750 of ICTA1988 which reduces the measure of local tax paid where that tax has been repaid to another person.

6. Subsection (4) sets out the commencement rule.

7. Subsection (5) ensures that subsidiaries that make retrospective a change to their accounting period across the date on which these

changes were announced, are brought immediately within the scope of the new clause.

8. Subsection (6) defines the term ‘accounting period’.

BACKGROUND NOTES

9. A CFC is a company which is not resident in the UK (but which is controlled by persons who are) and which is subject to a level of taxation of less than three quarters of that which it would have been subject to had it been resident in the UK.

10. The CFC rules stop UK companies reducing their UK tax liabilities by diverting profits to foreign companies, which they control and which are situated in low tax regimes. The rules work by, broadly, charging UK parent companies of CFCs on an amount equal to the profits that would otherwise avoid tax.

11. To fall within the Controlled Foreign Company rules, a subsidiary must be subject to a lower level of tax (LLT). For most subsidiaries, this test is defined by section 750 of ICTA 1988, which makes a comparison between the tax paid by the subsidiary and the tax that would have been payable if the subsidiary was subject to UK tax.

12. Some groups have arranged for a significant amount of income to arise in a subsidiary, which is not subject to tax under UK rules and which therefore distorts the comparison.

13. This clause closes that loophole by amending the operation of the lower level of taxation test to prevent this ‘UK excluded’ income distorting the test.

14. In some circumstances, tax paid by one company can be repaid to another associated person, either as a direct repayment or as a payment of unused tax credit. Unlike the rules that apply for double taxation relief, these payments are not currently recognised in determining the level of tax paid locally.

15. This clause also amends the operation of the lower level of tax test by reducing the amount of tax paid locally where it has been repaid in these circumstances.

EXPLANATORY NOTE

CLAUSE 45: LLOYD'S UNDERWRITERS: ASSESSMENT AND COLLECTION OF TAX

SUMMARY

1. Clause 45 allows for the repeal and amendment of certain provisions of Finance Act 1993 and Finance Act 1994 which set out administrative procedures for, and provides for the making of regulations relating to, the assessment and collection of tax from Lloyd's underwriters.

DETAILS OF THE CLAUSE

2. Subsections (1), (2), and (3) repeal section 173 of, and Schedule 19 to, Finance Act 1993 and amend the wording of section 182 of Finance Act 1993.

3. Subsections (4), (5), (6) and (7) repeal section 221 of Finance Act 1994 and renumber and amend the wording of section 229 Finance Act 1994.

4. Subsection (8) provides that for the purposes of making new regulations, the provisions of subsections (1) to (7) come into force when the Finance (No 2) Act is passed.

5. Subsections (9) and (10) provide that for all other purposes, the provisions of subsections (1) to (7) come into force by Treasury Order.

6. Subsections (11) to (13) allow for consequential amendments, and provide definitions of terms used in the Clause.

BACKGROUND NOTES

7. Underwriters at Lloyd's are taxed according to their share of the profits or losses of syndicates of which they are members. In order to facilitate the assessment and collection of tax from underwriters, Lloyd's managing agents are required to make returns to the Inland Revenue of syndicate profits and losses, computed for tax purposes.

8. Section 173 of, and Schedule 19 to, Finance Act 1993 apply administrative procedures for the assessment and collection of tax from individual members of Lloyd's. Section 221 of Finance Act 1994 applies these procedures to corporate members. The clause allows for the repeal of these parts of FA 1993 and FA 1994, together with related words in section 182 FA 1993 and section 229 FA 1994. The regulation-making powers in section 182 of FA 1993 and section 229 of FA 1994 will be widened.

9. This will enable the rules in Schedule 19 FA 1993 to be replaced by regulations. This will permit greater flexibility in amending and modernising the current procedures, for example by allowing for electronic filing of syndicate returns and by applying self-assessment principles to the determination of syndicate profits.

10. The current procedures will continue to operate until they are replaced by new regulations. This is achieved by the effect of subsections (8) and (9) of the Clause.

EXPLANATORY NOTE

CLAUSE 46: ENERGY ACT 2004 AND HEALTH PROTECTION AGENCY ACT 2004

SUMMARY

1. Clause 46 removes exemptions and redundant provisions relating to the United Kingdom Atomic Energy Authority and the National Radiological Protection Board. The removal of these provisions is consequential to changes provided for in the Energy Act 2004 and the Health Protection Agency Act 2004. In particular the removal of the exemptions for the United Kingdom Atomic Energy Authority reflect its changed role following the creation of the Nuclear Decommissioning Authority.

DETAILS OF THE CLAUSE

2. Subsection (1) introduces the clause.

3. Subsection (2) removes exemptions from income and corporation tax on certain property and investment income of the United Kingdom Atomic Energy Authority and the National Radiological Protection Board. This also affects in principle pension schemes run by the Authority but in practice there is no effect because the schemes are still subject to the normal rules for pension schemes.

4. Subsection (3) removes the equivalent exemptions from tax on chargeable gains.

5. Subsections (4) and (5) provide for when the exemptions cease to have effect. The minor differences reflect the fact that the United Kingdom Atomic Energy Authority will continue but the National Radiological Protection Board will cease to exist.

6. Subsection (6) provides that the removal of S349B(3)(g) shall not effect the application of S349B generally in relation to payments to the United Kingdom Atomic Energy Authority; to make it clear that payments to it are treated like payments to other companies when payers decide if they need to deduct tax.

7. Subsection (7) provides that the removal shall not affect any accounting period of the United Kingdom Atomic Energy

Authority ending before 1 April 2005 or any accounting period of National Radiological Protection Board ending on or before 1 April 2005.

BACKGROUND NOTES

8. The Energy Act 2004 changes the management of public sector civil nuclear liabilities. A consequence of the reorganisation is that the role of the United Kingdom Atomic Energy Authority in relation to nuclear decommissioning will change significantly. The exemptions applicable in its previous role are removed with effect from 1 April 2005 when the changes start.

9. The Health Protection Agency Act 2004 creates a new Health Protection Agency which will take over the functions of the National Radiological Protection Board which will cease to exist. The exemptions for the National Radiological Protection Board are removed from when these cease to have effect.