Tax and accounting – financial instruments

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Chris Lallemand considers the complex issue of tax and accounting for financial instruments with a particular focus on interest free loans

This article follows on from Paul Martin's 'Mind the GAAP' article in the May 2016 issue of Business Tax Voice about the impact of new generally accepted accounting practice (GAAP) on the quantification of taxable trading profits. I shall look in more depth at corporation tax and income tax adjustments for financial instruments, focussing mainly on loans to shareholders, but also considering some points on accounting and tax for company distributions. For simplicity, the article will not consider the complications created by transfer pricing, the hybrid mismatch rules for payments made on or after 1 January 2017 or deferred tax.

Background

Under old UK GAAP, where FRS26 (Financial Instruments: recognition and measurement) did not apply because the company was not listed and did not apply fair value accounting under either SI 2008/409 or SI 2008/410, there was no recognition of financial instruments (such as loans or derivatives) at a fair or discounted present value and FRS4 (capital Instruments) would have applied. The accounting treatment varied depending on the type of instrument:

- A loan would be recognised initially by a borrower at net proceeds (fair value of consideration received less issue costs), and thereafter at amortised cost, meaning the finance costs were allocated over the term of the debt at a constant rate.
- Derivatives would not be fair valued and accounting entries would arise from actual obligations created under the derivative instrument.
- Investments would have been measured at historic cost less diminution in value.

The accounting entries were reflected in the corporation tax computation, unless particular tax rules applied (such as the late paid or connected party rules for loans). An interest-free loan would usually generate no tax entries under the old UK GAAP and before F(No2)A 2015.

FRS102

Under FRS102, a basic financial instrument that is a financing transaction (one that it not at a market rate, such as a loan at a below market rate of interest) is initially measured at the present value of the future payments discounted at a market rate of interest, being an approximation to fair value. Thereafter, measurement is at amortised cost using the effective interest method using the rate as calculated at the start of the financial instrument, except where elections for fair value measurement have been made. The effective interest rate method exactly discounts the expected future cashflows to the instrument’s carrying value, which is its present value at recognition. There is an example of the calculation at paragraph 11.20 of FRS102.

Derivatives are not basic financial instruments under FRS102 and are accounted for at fair value, with fair value movements going through the income statement, unless the derivative is a designated accounting hedge. In that case, the fair value movements get allocated to other comprehensive income (OCI) until maturity or loss of hedge designation, when any balance left in OCI is transferred to the income statement.

Loans at below market rates of interest

In the case of a loan at below market rates of interest, there will therefore be quite a difference in the recognition of the loan and the accounting for interest under FRS102 compared to old UK GAAP. For example, an interest-free loan under old UK GAAP accounting (assuming FRS26 did not apply) would generally be recognised at its net proceeds, with no interest amounts accounted for or taxed. Under FRS102, however, the same loan (assuming it is a basic financial instrument) will be recognised at its discounted present value on initial recognition, with interest amortised (the unwinding of the discount) to the income statement over the life of the loan. For example, an interest-free loan for £100 repayable in four years' time, when at the date the loan was made the annual interest rate was 5% would be recognised as follows:

Year	Loan amount FRS4	End of year loan amount FRS102	Interest for the year under FRS102	FRS102 Annual interest rate
0	100	82.2		
1	100	86.4	4.2	5%
2	100	90.7	4.3	5%
3	100	95.2	4.5	5%
4	100	100	4.8	5%

The difference between the cash amount of a loan and the balance sheet value at initial recognition will be allocated to a balance sheet or equity account depending on the relationship between the borrower and lender.

When the F(No2)A 2015 loan relationship and derivative contract changes apply it is important to understand in which part of the profit and loss statement accounting entries are recognised under FRS102. In FRS102 there is one statement of comprehensive income made up of the income statement and the statement of other comprehensive income (OCI). These are comparable to the profit and loss account and statement of recognised gains and losses under old UK GAAP. When the F(No2)A 2015 loan relationship and derivative contract changes are fully effective, the actual tax charge will generally be based only on those accounting entries recognised in the ‘income statement’.

Corporation tax

The loan relationship and derivative contract regime for companies will calculate tax based on the accounting entries as modified for specific rules, although there are certain derivative contracts taxed as capital gains for corporation tax purposes. The amortised cost basis for accounting periods beginning before 1 January 2016 was set out in CTA 2009 s.313(4) which applied a basis of accounting using cost, as adjusted for cumulative amortisation, impairment, repayment or release – a different basis to the FRS102 amortised cost basis of accounting.

Grandfathering rules

If the loan or derivative contract was taken out in an accounting period beginning before 1 January 2016 and not varied in accounting periods beginning on or after 1 January 2016, then the pre F(No2)A 2015 Sch7 loan relationship and derivative contract rules with respect to the amortised cost basis for connected companies (CTA 2009 s349) and amounts recognised in equity (CTA2009 s.321 and s.605) will apply to tax the loan or derivative contract. This means the old UK GAAP accounting applies, which in the case of the interest free loan for £100 shown in the table above, will mean there is no interest to account for in the tax computation. Any FRS102 accounting entries for a loan between connected companies in this situation, that are different to the amortised cost basis under the CTA 2009 s.313(4) definition, will be ignored for corporation tax purposes. The legislation that applied before the F(No2)A 2015 rules continues to apply for the life of that loan.

Where the loan is to/from an individual shareholder, the amortised cost basis in CTA09 s.313(4) is not specified (as it would be for loans between connected companies). Thus FRS102 accounting adjustments for the company could create taxable or tax deductible amounts, subject to new CTA 2009 s.446A for accounting periods beginning on or after 1 April 2016 (which may deny loan relationship debits) and any application of the late paid interest rules (for example CTA2009 s.375). For the individual who is a creditor, however, they will be taxed on the interest income as it arises (when it is available to them).

New rules under F(No2)A 2015

As noted above, for loans and derivative contracts entered into in accounting periods beginning on or after 1 January 2016, it will be important to know which part of the statement of total comprehensive income or equity that financial instrument accounting entries should be allocated to. It bears repeating that this is because, generally, the taxable entries will only be those appearing in the income statement.

For new loans with below market rates of interest taken out in accounting periods commencing on or after 1 January 2016, the FRS102 entries will be the starting point for calculating any tax charge. You will need to consider avoidance provisions and also the amendments to the loan relationship regime in FA2016 Sch 7. These amendments can deny accounting debits where they relate to amounts accruing to an individual or a company located in a non-qualifying territory. One needs to consider the commencement dates of the different changes carefully as they may not be aligned. The aim of the amendments is to avoid a situation where the change of accounting basis creates taxable or deductible amounts that are not matched by an opposite deductible or taxable amount, just because of the change of accounting practice. However there is a small difference in commencement dates. F(No2)A 2015 Sch7 starts for accounting periods commencing on or after 1 January 2016, with no splitting of accounting periods crossing that date. The FA 2016, Sch7 amendments only apply for accounting periods beginning on or after 1 April 2016 with accounting periods crossing this date split for the purposes of commencement.

Transitional rules

Transitional rules are set out in F(No2)A 2015, Sch7. These spread transitional adjustments over five years (see paras 115-124) to take account of the different method of taxing accounting entries in OCI either side of the 1 January 2016 accounting period commencement date.

In addition, there are loan relationship disregard regulations (SI 2004/3256) and change of accounting practice regulations (SI 2004/3271), which can remove the effect of fair value accounting or spread adjustments on a change of basis over 10 years. The change of accounting practice regulations, SI 2004/3271, have been changed by SI 2016/1234 for accounting periods commencing on or after 1 January 2016. The change removes, from the scope of 10 year spreading, adjustments relating to OCI, that have already been dealt with under the F(No2)A 2015 five year spreading provisions for corporation tax.

HMRC has issued some draft guidance on corporation tax matters around interest-free loans.

Income tax

The position is different for unincorporated entities. There are no transitional rules, disregard regulations, or spreading provisions applying for fair value or present value adjustments on loan relationships and derivative contracts.

For business income tax purposes interest expenses are tax deductible as they are accounted for as being revenue in nature (ITTOIA 2005 s.29), provided they are expenses incurred wholly and exclusively for the trade (ITTOIA 2005 s.34). FRS102 accounting interest expense on an interest free loan may not meet the definition of an expense incurred for the purpose of the trade as in HMRC's view there is no outlay. Interest income, however is generally taxable according to the time at which it arises (is available for use) rather than when it is accrued for accounting purposes.

There was therefore always a potential mismatch in the timing of taxation of interest where one party to a loan was a UK company and the other a UK resident individual. For example, a loan from an individual to a close company, where the individual creditor was not a participator or an associate of a participator, nor someone who controlled the borrowing company, could result in tax deductible interest for the company in line with the accounting entries, while only being taxable on the individual when actually received.

For an unincorporated business, it is necessary to consider whether what is generated is a capital or a revenue item for income tax purposes. This is in contrast to the corporation tax rules for loan relationships and derivative contracts. For derivative contracts, the accounting entries may be allocated to OCI and will not be taxed until allocated to the income statement, if under FRS102 the derivative acts as a designated hedge.

HMRC has issued a paper on the FRS102 tax accounting implications for unincorporated entities.

Points on distributions

Where there are transactions between a company and its shareholders, it can be important to consider the company distribution rules. The ICAEW has published some draft guidance on the accounting implications for determining realised profits for company distributions. The guidance takes account of the adoption of FRS102.

A point to note on the impact for distributable reserves is that: *…an undervalue transaction with a shareholder or sister company is capable of being a distribution, because it involves in substance an element of gift to the transferee (extract from para 2.6A).*

One way of avoiding the application of the present value and FRS102 amortised cost basis of accounting for a below market rate of interest (say interest-free) loan is to make it repayable on demand. However from a legal perspective if there is no prospect of immediate repayment, this may still be regarded as a distribution, probably as a result of counterparty risk issues. In relation to an interest free loan from subsidiary to shareholder parent the ICAEW paper comments: *This transaction is accounted for as a distribution by the subsidiary. It is also a distribution as a matter of law because it is at undervalue…… An interest-free loan which is legally repayable on demand may also be a distribution as a matter of law if it is at undervalue (eg, if there is no ability to repay it immediately) even though there is no distribution for accounting purposes (extract from para 9.55).*

One consequence of the change in the income taxation of dividends introduced from April 2016 is that the tax rate applicable to a charge under the loan to participator rules has increased from 25% to 32.5%. For those interested in accessing cash from their companies without immediately incurring an income tax charge, the percentage of cash available in the hands of a shareholder using a loan compared to taking a dividend, is higher in 20016/17 than in 2015/16, as a result of the removal of the income tax credit on dividend income. This assumes an individual shareholder is subject to the higher rate of income tax, that the beneficial loan interest provisions do not apply, and the dividend income nil rate band has been used up.

When considering strategy for accessing cash via loans, in addition to the range of tax anti-avoidance provisions, it will be advisable to consider the company law distribution points too.

The question also arises as to whether the FRS102 accounting entries on an interest-free loan for a fixed period (a ‘term’ loan) from a company to a shareholder could result in a tax distribution. The relevant definition of distribution for a transfer of assets (for example cash) would be CTA10 s.1020. This compares the amount or value of any benefit received by a shareholder, to the market value of any consideration they give. Market value is assessed according to CGT rules.

From the company’s perspective, sterling cash is not an asset for CGT purposes (TCGA s.21(1)(b) and neither, for the original lender, is a straightforward loan to a shareholder (TCGA s.251). There would therefore be no gain or loss to account for in respect of the cash or the loan note for the company.

An individual shareholder has, however, received cash in return for an agreement to repay the same amount at a later date under a loan note, with a present value less than the cash received. Under FRS102, assuming the interest-free loan was a term loan, the company would account for a distribution on initial recognition of the receipt of the loan for the transfer of the cash.

How would this be treated for tax?

Richard Bramwell’s book ‘Taxation of Companies and Company Reconstructions’ (section E1.2.12 to E1.2.14) refers to HMRC’s revised 2005 guidance, which states that a reference to ‘assets’ in CTA10 s.1020 does not include ‘cash’. It also refers to the *Noved* case ([2006] STC (SCD) 120) in which the Special Commissioners in *Noved* suggested otherwise. However, it may be that HMRC considers s.1020 only applies to outright transfers of assets. What the company has obtained in consideration for the cash is a future receivable, so this may not be regarded as an outright transfer.

While this sort of situation may not often arise, a tax adviser often has to deal with the consequences of transactions already effected and perhaps documented before the tax computation is prepared. HMRC has informally indicated that an interest-free loan to an individual shareholder, where the company uses FRS102 accounting, will not on its own create a distribution for tax purposes. However, it does seem odd that something that can be regarded as a company law distribution is not considered a distribution for tax purposes.

If there is no charge to income tax on an individual recipient, and a main purpose of the arrangements is to avoid a CTA10 s.455 loan to participator charge, then CTA10 s.464A will levy a charge at the loan to participator charge rate, on the value of the benefit provided.

There have now been several references in Government consultation documents and papers to the differential between income tax, CGT and corporation tax rates. For example paras 5.1-5.3 in the 9 December 2015 consultation on Company Distributions, and the Office of Budget Responsibility (OBR) November 2016 economic and fiscal outlook report. Indeed, the OBR expects the rate of incorporation to increase as the CT rate decreases, despite the change in dividend tax rates.

Prior to 1989 there was apportionment of undistributed company income (ICTA 1988 s.423-430 and Schedule 19). If we go back to that form of tackling tax-motivated incorporation businesses and advisers may need to pay closer attention to the calculation of distributable reserves.

There may be other ways of dealing with the issue; for example, different corporation tax rates of tax for certain types of activity, increasing dividend taxation rates further, and restricting the level of deductions for certain types of costs. The old apportionment rules removed the cost of interest deductions in the calculation of profit for apportionment purposes.

Currently, interest can be an attractive means of extracting money from a company not affected by the restriction on interest deductions from 1 April 2017 included in Finance Bill 2017. It will be interesting to see whether companies below that £2m net interest threshold will retain the benefit of a full tax deduction for business interest expense in all cases.