CHAPTER 12A
LOAN RELATIONSHIPS - BASICS

This chapter looks at loan relationships covering in particular:
- the definition of a loan relationship;
- the treatment of income and expenses;
- the purpose of the loan relationship;
- non trade loan relationship deficits;
- prior period adjustments;
- capitalised interest;
- ceasing to be UK resident, and
- loans for unallowable purposes.

12A.1 Definition

A company has a loan relationship if it:

- owes or is owed money as a result of a money debt, and
- that debt arose from a transaction for the lending of money.

A money debt is generally one that is settled by the payment of cash.

A money debt can also be settled by the transfer of another money debt or the issue or transfer of shares.

A transaction for the lending of money includes not just the actual lending of money, but also the creation of debt by issuing an instrument to evidence the debt. An instrument is a written promise to repay a debt i.e. notes, bonds, or bills of exchange between a borrower and a lender.

Illustration 1

A bank loan is a loan relationship as it arose from the lending of money, and is a money debt as the company will settle the debt through the payment of cash.

A trade creditor (where goods or services are paid for on a later date in accordance with credit terms) is a money debt as it will be settled in cash. However it did not arise as a result of the lending of money and as such is not a loan relationship.
Likewise, the person who provided the goods or services and is owed the money (the trade debtor) does not have a loan relationship.

The provision of a service is not the lending of money. However, if an instrument (a written promise to repay a debt) is drawn up to evidence the amount owed as a result of the work done, that is a transaction for the lending of money and creates a deemed loan relationship that will be settled in cash.

Interest, impairment losses (bad debts) and foreign exchange gains and losses on money debts are always included in the loan relationship rules, even if the underlying debt is not a loan relationship.

Example 1

Which of the following constitute a loan relationship?

a) Debentures in a company
b) Government gilts
c) Bank deposit account
d) Bank overdraft
e) Debtors ledger
f) Loan to an employee

12A.2 Treatment of income and expenses

The legislation uses accounting terminology so you must ensure that you are familiar with these terms:

- Debits are expenses
- Credits are income

Loan relationship income and expenses include:

- Interest payable and receivable,
- Foreign exchange gains and losses,
- Costs to issue the debt,
- Debt collection costs,
- Pre-loan and abortive expenses,
- Profit or loss on the acquisition or disposal of an existing loan relationship (called a related transaction),

CTA 2009, s.478 & 479
CTA 2009, s.307
CTA 2009, s.328
CTA 2009, s.329
CTA 2009, s.304
• Loans written off (known as impairments or bad debts) - this would result in an expense in the company writing the debt off,

• Release of loans - this is where the debtor is no longer required to pay back the loan. This would result in:
  
  o an expense in the company which has released the debt, and
  o income in the company that has had their obligation to pay the debt released (unless the release is part of a statutory insolvency arrangement).

For tax purposes we follow the accounting treatment, i.e. we account for income and expenses on an accruals basis.

This means that we will generally use the income and expenses in the Profit and Loss Account (UK) or Income Statement (International) produced by the company as these will have been prepared in accordance with UK or International generally accepted accounting practices.

We also take into account any profits and losses shown in the company's Statement of Total Recognised Gains and Losses (UK) or Statement of Changes in Equity (International).

One exception to this is the writing off or release of a loan to a participator of a close company which had given rise to a section 455 tax charge in the company.

This write off or release will be treated as dividend income for the shareholder involved as they no longer have to repay the loan to the company. No deduction is allowed for the expense in the close company.

**Example 2**

Which of the following are eligible for tax relief under the loan relationship rules?

a) Interest payable
b) Early redemption penalties
c) Bank arrangement fees
d) Amounts written off loans (bad debts)
e) Loss on disposal of loan stock
Example 3

Soria Ltd borrows £10,000,000 from a bank on 1 March 2012 for trade purposes. Interest of 5.75% is payable quarterly in arrears. The fees for arranging the loan came to £75,000 and were payable in full on 1 March 2012 when the documentation for the 5 year loan was put in place.

Calculate the amount of corporation tax deduction available for the loan in respect of Soria Ltd’s year ended 30 September 2012.

12A.3 Purpose of the loan relationship

We need to establish the purpose of the loan relationship to determine on which line of the corporation tax computation the income and expenses need to be included.

If the loan was for trade purposes, any associated income and expenses would be included in the calculation of trade profits. A loan will have a trade purpose if the funds are used to generate income which is taxed as trade profits.

Examples of a loan for trade purposes include:

- a loan to buy plant and machinery or a factory for use in the company’s trade,
- a bank overdraft to fund the working capital of the business, and
- a bank loaning money to its customers.

However, if the loan relationship arose for non trade purposes, the income and expenses on these non trade loans are pooled together and included as non trade loan relationship income or deficit for the period.

Examples of non trade loan relationships include:

- a loan to buy an investment property or shares,
- a company loaning money to its employees or customers,
- a company receiving interest on positive bank deposits, and
- interest on overpaid or underpaid corporation tax.
Example 4

Classify the following loans as trading or non trading:

a) Loan to buy a factory
b) Loan to buy rental premises
c) Loan to buy shares on the stock market
d) Loan to buy shares in a trading subsidiary company
e) Funds lent to a subsidiary for the purpose of its trade.

12A.4 Non trade loan relationship deficits

If, having pooled together all of the non trade income and expenses a deficit arises, it can be relieved in the following ways:

1. Offset in the current year against total profits before qualifying charitable donations.
   
   The company can choose the amount it wishes to set off against total profits, it is not an all or nothing claim.

2. Carried back against non trade loan relationship income in the previous 12 months.
   
   A carry back claim is all or nothing. This means that if there is sufficient deficit to do so, the non trade loan relationship income must be taken down to nil.
   
   The non trade loan relationship deficit available to carry back is the deficit of the current year to the extent that it has not been relieved by a current year or group relief claim.

3. Carried forward against non trade income. This is automatic so no claim is required.
   
   A claim can be made to offset only part of the loss in the accounting period immediately following the deficit period and carry forward a larger deficit, or to ‘skip’ that period entirely and wait until the following period to offset the deficit.

4. A group relief claim can be made for any amount of the loss.

   These claims are independent and can be made in any order. All claims must be made within 2 years of the deficit period.
12A.5 Prior year adjustments

Prior year adjustments are made when a company:

- changes the accounting policies it uses, or
- has made a fundamental error in a previous period.

The company will need to restate the prior year accounts to ensure that the figures are comparable and that the brought forward figures are accurate.

The tax treatment depends on the reason for the prior year adjustment.

An income or expense due to a change in accounting policy is included for tax purposes as if it were incurred on the first day of the period in which the change occurred.

However, if the change is due to a change in accounting standards, such as a move from UK to International GAAP, the adjustment is spread over 10 years starting with the year in which the change occurred.

If the company ceases to be within the charge to corporation tax before the end of the 10 year period, the remaining income or expense is brought in the final accounting period.

An income or expense due to the correction of a fundamental error in a prior period is treated for tax purposes as occurring in the period in which the error occurred. This may mean that returns for previous periods need amending, and tax may become payable by or repayable to the company.

Illustration 2

Portico Plc holds debentures in Mora Ltd, an unconnected company. In the accounts to 31 December 2012 the debentures were recorded at £100,000 as the company was using amortised cost accounting. In the year to 31 December 2013 Portico Plc adopts IAS and as a result the debenture is restated at its fair value of £122,000. During the year to 31 December 2013 a credit of £6,000 was made to the income statement for changes in fair value.

For tax purposes we need to bring in £22,000 which is the increase in value of the debenture as a result of the change of accounting policy. This is spread over 10 years, starting with the year of change, 31 December 2013.

In the year to 31 December 2013 as well as showing the non-trading (LR) credit of £6,000 we need to bring in one tenth of the £22,000; thus the total non trading loan relationship credit will be £6,000 + £2,200 = £8,200.
Example 5

Terra Plc holds treasury stock valued in the accounts to 31 March 2012 at £200,000. In the year to 31 March 2013 Terra Plc adopts IAS; on doing so the treasury stock is restated at £192,000.

During the year to 31 March 2013 £9,500 is credited to the income statement in respect of the treasury stock.

You are required to show the amounts to be brought in to the tax computations for the year to 31 March 2013.

12A.6 Capitalised interest

In some situations, for example the construction of a building, interest can be capitalised. This means that the debit is included within the cost of the fixed asset rather than being treated as an expense in the Profit and Loss Account.

In these circumstances a deduction is still allowed when the expense is incurred. This does not apply if the asset in question is an intangible fixed asset as a deduction will be given for the capitalised interest through annual amortisation. No debit can be brought into account for the interest at a later date even if it is reflected in the Profit and Loss Account at that date, i.e. through writing down (impairing), amortising or depreciating the asset.

12A.7 Ceasing to be UK Resident

If a company ceases to be UK Resident, it is deemed to dispose of its loan relationships and immediately reacquire them at fair value immediately before it becomes non UK Resident.

Fair value is the amount that the company would receive to transfer its rights under the loan relationship, or the amount the company would have to pay to discharge its liabilities under it, to a knowledgeable and willing person dealing at arm’s length.

This will result in a profit or loss arising on the deemed disposal, which is included as a trade or non trade income or expense as appropriate.
12A.8 Loans for unallowable purposes

If a loan is made for an unallowable purpose:

- Expenses are not allowable
- Foreign exchange gains are not taxable

An unallowable purpose is where the loan relates to company activities which are not within the charge to corporation tax, or one of the purposes of the loan is tax avoidance.

Examples of unallowable purposes include:

- A company borrows £5m from the bank and then becomes insolvent. It sells all of its assets, but the loan remains outstanding and continues to accrue interest. The company would have a non-trade loan relationship deficit which it could potentially offset against other profits e.g. using a carry back claim. However, as the company no longer carries out any activities that are within the scope of corporation tax, the loan has an unallowable purpose and the interest is not allowable.

- A golf club receives subscriptions from members which are not subject to corporation tax, and green fees from non-members which are within the scope of corporation tax as this is effectively a business activity. It takes out a loan to finance the construction of a new club house. The interest expense would have to be apportioned – the amount relating to the members would be disallowed as it relates to activities that are outside the scope of corporation tax, the remainder would be an allowable expense for corporation tax purposes.

Whether tax avoidance is one of the purposes will be a question of fact. The rules can cover situations where money is borrowed to enter a tax avoidance scheme, although the borrowing of money is not part of the scheme.

Example 6

Gable Ltd had the following income and expenses in the year ended 31 December 2012:

<table>
<thead>
<tr>
<th>Description</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit</td>
<td>300,000</td>
</tr>
<tr>
<td>Rental income</td>
<td>15,000</td>
</tr>
<tr>
<td>Interest paid (on loan to purchase a factory)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Interest paid (on loan to purchase a rental property)</td>
<td>(1,900)</td>
</tr>
<tr>
<td>Interest received (on loan to subsidiary)</td>
<td>52,300</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>361,400</td>
</tr>
</tbody>
</table>

Calculate Gable Ltd’s TTP for the year ended 31 December 2012.
Answer 1

<table>
<thead>
<tr>
<th>Money debt?</th>
<th>Transaction for lending of money?</th>
<th>LR</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Debentures in a company</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b) Government gilts</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c) Bank deposit account</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d) Bank overdraft</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>e) Debtors ledger</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>f) Loan to an employee</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Answer 2

All items are tax deductible as they are all expenses included in the accounts that relate to a loan relationship, or are expenses specifically included within the loan relationship rules.

The arrangement fees will be spread over the period on the loan in accordance with generally accepted accounting practice.

Answer 3

The deduction available will be:

£

Interest payable
10,000,000 × 5.75% × 7/12
335,417

Loan arrangement fees
75,000 × 1/5 × 7/12
8,750

Total deduction allowed in arriving at trade profits
344,167
Answer 4

(a) The loan taken out to buy the factory is a **trading loan**, providing the factory is used by the company for the purpose of its trade. If the intention is to rent out the factory, it would be a **non trade loan**.

(b) The loan taken out to buy rented premises generates UK property business income, therefore it is a **non trade loan**.

(c) The loan taken out to buy shares on the stock market produces dividend income, again this is not trade profit, so is a **non trade loan**.

(d) The loan taken out to buy shares in the trading subsidiary is also a **non trade loan** because these shares will generate dividend income, not trade profit, for the company.

(e) The loan taken out to lend money to a subsidiary for the purposes of its trade is again a **non trade loan**, because the loan is not taken out to fund the trade of the lending company. This is on the assumption that the lending company is not a bank.

Answer 5

The adjustment on moving to IAS is a debit of £8,000. This will be brought in over ten years beginning with the year to 31 March 2013.

A debit of £8,000/10 = £800 together with the credit for the year of £9,500 is brought in, giving a net credit of £8,700.
Answer 6

<table>
<thead>
<tr>
<th>Description</th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>361,400</td>
<td></td>
</tr>
<tr>
<td>Add: Interest paid (on loan to purchase a rental property)</td>
<td>1,900</td>
<td></td>
</tr>
<tr>
<td>Less: Rental income</td>
<td>(15,000)</td>
<td>(52,300)</td>
</tr>
<tr>
<td>Interest received (on loan to subsidiary)</td>
<td>(52,300)</td>
<td></td>
</tr>
<tr>
<td>Trade Profit</td>
<td>296,000</td>
<td></td>
</tr>
<tr>
<td>UK Property Business</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Non-trade credit (Loan Relationships)</td>
<td>52,300</td>
<td></td>
</tr>
<tr>
<td>Non-trade debit (Loan Relationships)</td>
<td>(1,900)</td>
<td></td>
</tr>
<tr>
<td>Non-trading profit (Loan Relationships)</td>
<td>50,400</td>
<td></td>
</tr>
<tr>
<td>TTP</td>
<td>361,400</td>
<td></td>
</tr>
</tbody>
</table>

**Note**

The loan to purchase the factory is a trading loan. Therefore, the interest expense of £4,000 is an allowable trading deduction and no further adjustment is required.