A DETAILED REVIEW OF THE NEW UK TAX RULES ON CORPORATE DEBT

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A DETAILED REVIEW OF THE NEW UK TAX RULES ON CORPORATE DEBT

1. Preface

I trained as a chartered accountant with a small firm from 1974 to 1977. While most of the work comprised preparing accounts from incomplete records, staff were also responsible for preparing the tax computation based upon the accounts.

I developed an interest in tax from such computational work. Accordingly, when I qualified as a chartered accountant I decided to specialise in tax as well as moving to an international accounting firm.

The Chartered Institute of Taxation is the only professional body in the United Kingdom devoted solely to the development of the practice of tax. Accordingly, I wanted to join as quickly as possible and successfully took the examinations to become an associate member in April 1978.

At that time, the Institute also had a higher level examination for admission to fellowship. I planned to take the fellowship exam after gaining a few years of practical experience. However, the Institute found the fellowship exams expensive to organise given the small number of candidates. A year so after I became an associate, the fellowship exam was abolished and replaced by admission to fellowship by thesis.

For the next decade and a half, although I was a full-time tax specialist and heavily involved with the Manchester branch of the Institute, I could never think of anything that I wanted to write a thesis upon.

All subjects seemed to fall into two categories:

- Very interesting areas where however there was a risk of disseminating intellectual property better kept within my firm.
- Routine areas where there was no risk of divulging intellectual property but too boring to motivate me to write a thesis.

The starting point for change was the Finance Act 1993, which revised the UK corporate tax law on foreign exchange gains and losses. This led to my taking examinations again after a gap of 17 years when in April 1995 I successfully took the examinations to become an associate member of the Association of Corporate Treasurers.

The following the year, the Finance Act 1996 revised, from the ground up, the UK corporate tax law on debt and interest. It suddenly occurred to me that here was a subject that I was passionately interested in, and on which I could write a thesis without risking a leakage of valuable intellectual property.

With the concurrence of the partners to whom I reported, I registered my thesis title and a synopsis with the Institute on 10 September 1996. The Institute's rules require the submission of a thesis within three years of registration, but I never expected to take such a long time. Indeed, I put into my partner personal plan that I would submit the thesis by 30 June 1997.

With hindsight, I clearly had no appreciation how difficult it was going to be to find time to progress the thesis. Given the pressures of the working day, only weekends and holidays provided any available time. Progress was made in fits and starts. I.e. for a few weekends consecutively I would spend Sundays working in the office and then another long gap would ensue. When 1999 started, I had about 8,000 words written, all part of the introduction before addressing the FA 1996 changes themselves. I could also see that the deadline was now only nine months away.

A DETAILED REVIEW OF THE NEW UK TAX RULES ON CORPORATE DEBT

By devoting many weekends and virtually all available vacation time from January until the end of August, I managed to get the thesis finished with just two weeks to spare.

By the end of May, I had a draft of 41,000 words. While the Institute's rules limit the maximum length to 25,000 words, I considered it impossible to write to a set length. Instead, I always planned to write the text I felt appropriate, and then edit it downwards. However, performing the level of surgery required was very difficult, and risked killing the thesis. I found the exercise quite educational since it forced me to concentrate on the key ideas and also provided endless practice at rewriting text to say the same thing with less words. The thesis as finally submitted contained 24,995 words, comprising sections 2 - 11 and 13 of this document along with the equivalent parts of the table of contents.

I am now waiting to hear whether the thesis will be accepted. This process normally takes about three months.

For the convenience of readers who do not have the legislation readily to hand, I have included in section 12 almost all of the legislation mentioned in this document.

Needless to say, the thesis represents only a personal effort by myself. It does not constitute professional advice, and should not be relied upon by any person for any purpose. No responsibility is accepted by myself or by PricewaterhouseCoopers to any person so doing.

Mohammed Amin

September 1999

2. Registered synopsis

My goal is to review in detail the tax rules on Loan Relationships enacted in Chapter II of FA 1996 including the related Schedules, excluding Schedule 10 (Collective Investment Schemes) and Schedule 11 (Special Provisions for Insurers).

I propose to cover briefly the historical reasons why change was considered necessary by the Inland Revenue, and also disadvantages to taxpayers from the "old system." I will then consider in detail how the "new system" works, with particular emphasis on:

- Boundaries (e.g. what is a loan relationship)
- Internal coherence and consistency
- Interaction with the foreign exchange rules
- How the system fits with Company Law and UK accounting standards
- Anti-avoidance
- Tax planning possibilities
- Computational aspects, illustrating how "mark to market" and "authorised accruals" would be applied both to straightforward and to more complex situations.

Coverage of the transitional provisions will be restricted to matters having continuing effect, so that planning points requiring action prior to 31 March 1996 will not be covered.

The taxes covered will be income tax, capital gains tax, and corporation tax including corporation tax on chargeable gains. There will be no coverage of VAT or stamp duties, and I believe that inheritance tax and social security contributions are not in point.

3. Thesis guide

3.1. Date of law

The law is taken at 26 July 1999, immediately prior to enactment of FA 1999, apart from section 7.3.2.4.

3.2. Citation convention

Section numbers or schedule and paragraph numbers not otherwise qualified refer to FA 1996.

Quotations are printed in italics.

4. Economic Overview

4.1. Purpose

This section discusses the increasingly sophisticated ways of dividing up the returns of a business enterprise.

4.2. Debt free company with single owner

All of the economic return accrues to the sole owner, to be retained within the company or extracted.

4.3. Incurrence of trade debt

The simplest type of borrowing is trade credit. Typically, there is no explicit return to the supplier for providing the credit.

Providing the credit gives the supplier no right to share in the profits of the enterprise. There is a risk of non-payment on insolvency, although company law gives creditors payment priority over shareholders.

4.4. Debt finance from third parties

Unlike trade credit, these financiers may have no other dealings with the enterprise. They simply provide finance for some return, traditionally fixed without reference to the profits.

Debt	**Equity**
Fixed returns. No participation in profits	All the economic return after fixed payments on debt
Repayment priority over equity	Receives the residue after repaying debt

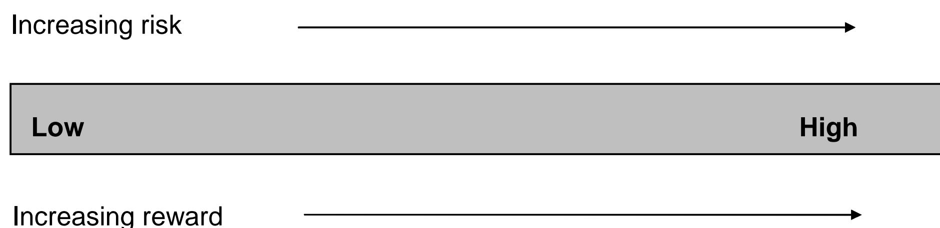
The debt can be subdivided e.g., with convertible debt the financier may accept a lower fixed return in exchange for an option to convert into shares. This now gives three categories.

Regular Debt	**Convertible Debt**	**Equity**
Fixed coupon. No participation	Lower fixed coupon. Participation via conversion option	All residual economic returns
Priority repayment over equity	Priority repayment over equity	All residue after repaying debt

There is endless scope for further sub-division.

4.5. The spectrum of risk and reward

Overall, economic theory indicates that there is a spectrum of risk and reward:



The instruments in this spectrum grow in variety. Financial advisors continuously devise new ways to partition the enterprise's return to satisfy the risk/return profile desired by different investors. The more closely the instrument matches the investors' risk/reward requirements, the less "waste" from providing the investors with economic returns greater than the bare minimum they would accept.

The following short list illustrates just some of the instruments devised, in approximate order of increasing risk/reward.

- Puttable debt - bonds where the holders can require early redemption.
- Bonds
- Callable bonds - the issuing company can redeem early.
- Zero coupon bonds
- Convertible bonds
- Preference shares
- Property linked certificates - bonds where interest and redemption are linked to property index movements.
- Equity linked stock - bonds where interest and redemption are linked to an equity market index.
- Ordinary shares
- Warrants – rights to subscribe for new shares.

4.6. The challenge for the tax system

All of the instruments listed, and others, were devised to enable issuers and investors to satisfy their commercial objectives, and not necessarily with any tax considerations in mind.

The tax system is required to deal with such instruments, from the perspective of issuers and investors, while meeting the standard goals[1] of:

- Equity
- Neutrality

- Certainty
- Administrative efficiency

5. Taxation History

5.1. *Purpose*

This section illustrates how the old law developed piecemeal in response to financial innovation.

5.2. *The capital / revenue divide*

The tax system inherited from agricultural society a fundamental distinction between "capital" and "revenue." This has always caused difficulty, both generally and with money lending.

5.3. *Specific difficulties and legislative or judicial "remedies"*

5.3.1. Premiums on debt repayment

If Lender loans £100 to Borrower, for five years at 10% pa, the whole return of £10pa is taxable income.

The Lender's overall return is still 10% pa if the borrower pays interest at 7%pa and repays the £100 five year loan at a premium of £18.32. Is only £7pa taxable revenue and the premium of £18.32 a tax-free accretion to capital?

5.3.1.1. CIR v Thomas Nelson & Sons Ltd

This straightforward issue was apparently first litigated in 1938, CIR v Thomas Nelson & Sons Ltd, 22 TC 175. The taxpayer had lent money to its Indian subsidiary for 10 years at 3% pa. On repayment a premium was also payable, calculated at varying rates over the life of the loan. The lender's overall effective return varied between 5% and over 5½%.

The court held that the premium was taxable as interest. Lord President Normand said, "*The premiums are part of the consideration given by the borrowers for the use of the capital lent to them, and part of the creditor's share of the profit which the borrower ... is presumed to make from the use of the money.*"

5.3.1.2. Lomax v Peter Dixon & Son Ltd

Premiums soon featured again in Lomax v Peter Dixon & Son Ltd 25 TC 353, which highlights tax problems only fully addressed by legislation 50 years later.

The writer's close reading of the facts suggests that the taxpayer restructured the debt owed by its Finnish subsidiary to avoid tax, and succeeded.

Very briefly:

- Peter Dixon & Son Ltd (PDSL) was a UK resident newsprint manufacturer.
- Its Finnish subsidiary O Y Toppilla (OYT) manufactured wood pulp.
- By 1933, OYT owed PDSL £319,600.
- On 11 November 1933 the debt was converted into interest bearing loan notes:

- OYT issued 680 notes of £500 each to PDSL. As 680 x £500 = £340,000 the notes were issued at a 6% discount.
- The notes were redeemable in tranches at £600 each, a 20% premium.

The Court of Appeal held that the discount and premium were non taxable.

Lord Green MR considered debenture issues by companies:

1. a normal company of "good" credit rating could issue debentures at par with "normal reasonable" rates of interest.
2. if the credit rating were "exceptionally good" the debenture could be issued at a premium, giving an effective return to the investor lower than for the merely "good" company. Lord Greene pointed out that the investor would be taxable on all the interest received, without relief for the premium outlay.
3. conversely, the "extremely good" company could issue debentures at par with a lower rate of interest.

Actuarially scenarios 2 & 3 were identical, but in 3 the investors would pay less tax as they received less interest.

A company of "below normal" credit rating could issue at par and pay a higher interest rate, taxable in full even though partly compensating for capital risk. Conversely it could issue debentures with normal interest rates but at a discount or issue at par with a premium on redemption. The discount or premium would compensate for capital risk, in a non-taxable way.

Lord Greene's analysis shows that he fully recognised the economic equivalence of interest, discount and premium.

However, the tax system required him to dissect PDSL's transactions with OYT into separate components for interest and discount/premium. As the interest rate was considered reasonable, the discount/premium retained their capital nature and were not to be regarded as "disguised interest".

5.3.2. Losses on bonds

While gains from bonds were tax-free (except where disguised interest) there was conversely no mechanism for investors (apart from financial traders) to receive relief for losses on bonds, whether from market value fluctuations or debtor insolvency.

5.3.3. Capital gains tax

Before 1965, economic gains were either taxable as income or were tax-free as being capital. Capital gains tax diluted the distinction.

However, debts have always presented capital gains tax difficulties.

With a debt repayable at par, the lender is unlikely to make a capital gain from selling the debt. (In general, a gain requires debt at a fixed interest rate and market interest rates to fall.) However, a loss is always possible from insolvency.

Accordingly, capital gains tax has always excluded some debts (usually referred to as "simple debts") while including others (typically "debts on a security.") The boundary between excluded/included debts has been a source of much difficulty, complicated further by the 1984 introduction of "qualifying corporate bonds" (QCB's).

5.3.4. Bond washing (selling securities with interest)

Interest being taxable and bond sales proceeds tax-free invited "bond washing."

5.3.4.1. Wigmore v Thomas Summerson and Sons Limited 9TC 577

The tax treatment of a seller of bonds part way through an interest period was first litigated in 1925.

The company sold a holding of War Stock making a profit. The Inland Revenue unsuccessfully assessed the company on interest accrued up to the sale date.

Rowlatt J perceptively analysed the financial economics, pointing out that dissecting the sale price into capital and accrued interest (as proposed by the Inland Revenue) had to be financially incorrect.

He analysed a sale of £400,000 nominal value of War Loan on 1 March, 3 months before the 1 June interest payment date. Arithmetically, 3 months interest, £5,000, was accrued. (5% x £400,000 x 3/12 = £5,000). However, it would be wrong to say that, of the total price paid, £5,000 must relate to the accrued interest. "*To my mind it is absurd to say that a person is paying £5,000 in March for £5,000 to be paid in June. He does not do it*".

Accordingly it would be necessary to value the right to receive the interest, i.e. compute "*the expectancy of the interest*". That would be highly judgmental and not a proper foundation for taxation.

5.3.4.2. The opportunity for tax avoidance

The Thomas Summerson decision enabled tax avoidance. By selling stock with accrued interest, the seller escaped tax. If the stock continued to be held and the interest received, tax would arise.

If all market participants were individuals paying tax at 40%, the tax saving opportunity would be illusory. Market prices would react to neutralise the tax effect. E.g. just before an interest payment date no individual would be willing to pay full value for the interest accrued, since he would have a definite loss equal to his tax liability on receiving the interest.

However, the markets have many participants, e.g. pension funds and charities who are tax exempt. Also securities dealers can ignore the capital / interest distinction. Accordingly, market prices generally do not eliminate the tax saving for individuals so bond washing would enable tax avoidance.

5.3.4.3. Initial legislative counteraction against bond washing

Parliament acted with FA 1927 S.33 targeting the avoidance of super tax (but not income tax) by the sale of securities cum interest. It eventually became ICTA 1970 S.30.

Reviewing ICTA 1970 S.30 shows that it would prevent only the most blatant higher rate tax avoidance.

5.3.4.4. Fresh case law: Schaffer v Cattermole 53 TC 499

In this 1980 case, the taxpayer sought relief from tax on purchased accrued interest. The judges expressed some sympathy with the taxpayer's analysis but saw no grounds for deviating from the Thomas Summerson decision.

Possibly due to this confirmation of the law, the personal financial press promoted bond washing.

5.3.4.5. Additional legislation against bond washing

FA 1985 legislated the apportionments argued for in Thomas Summerson and Schaffer.

While such apportionment is imperfect (as Rowlatt J demonstrated in Thomas Summerson) it improved the matching of taxable income and financial income.

5.3.5. Bonds without an interest coupon (zero coupon bonds)

5.3.5.1. Lord Howard de Walden v Beck 23 TC 384

In 1940 the courts first considered what are now called zero coupon bonds. The case is most clearly analysed by focusing on one set of transactions.

On 11 December 1993 the taxpayer paid a company £259,380. It issued him 120 promissory notes, face value £3,750 each. The first was payable on 31 March 1934, the remaining 119 at quarterly intervals. Over 30 years the taxpayer would receive 120 x £3,750 = £450,000.

The notes could be regarded:

- As entirely capital payments, with no taxable income. This was argued by the taxpayer, unsuccessfully.
- As 120 instalments of an annuity, entirely taxable income. The Inland Revenue never argued for this. Wrottesley J in the High Court mentioned judges' reluctance to reach such conclusions.
- As partly income and partly capital.

If partly income and partly capital, how should the notes be dissected?

Alternative 1

Analyse each note as a separate zero coupon bond.

The taxpayer demonstrated that the notes had an internal rate of return of $4^{1}/_{16}$% pa compounded quarterly. Looking for brevity at just the first and last notes, the writer calculates the following outcomes:

Note number	Face Value of note	Net Present Value of note on Issue	Interest Element taxable when note repaid
1	£3,750	£3,712	£38
120	£3,750	£1,115	£2,635

The Commissioners chose this dissection method, correctly in the writer's opinion.

Alternative 2

The Crown argued for regarding all 120 promissory notes together as partial repayments of a loan.

Such calculations had been approved in Scobies Case 4 TC 478 & 618 to dissect an apparent annuity. The High Court ruled that this method was correct.

The writer illustrates this as follows:

Quarter 1	Capital owed £259,380	
	Interest at $4^{1}/_{16}$% for 1 quarter	£2,634
	Capital element (balancing figure)	£1,116
	Total payment	£3,750
Quarter 120	Notional capital owed £3,712	
	Interest at $4^{1}/_{16}$% for 1 quarter	£ 38
	Capital element	£3,712
	Total payment	£3,750

The Crown accepted that difficulty would arise if, say, one note out of the sequence was sold and held by a third party on maturity.

Alternative 3

Although Justice Wrottesley found for Alternative 2, on page 401 of the report he expresses personal preference for an entirely different method, where each note comprises the same amount of interest and of capital. With 120 notes, each would comprise £2,161 capital and £1,589 interest.

The writer considers this commercially unrealistic, ignoring compound interest despite a 30 year time period.

5.3.5.2. Ditchfield v Sharp1983 STC 590

After 40 years zero coupon bonds reappeared in this case.

Very briefly, on 23 May 1969, a UK company Berger Jenson & Nicholson Ltd ("Bergers") purchased a group of companies from Celanese Corp. As part of the consideration, Bergers issued Cel Euro NV (a Dutch subsidiary of Celanese Corp) a promissory note, for £2,399,000 payable on 1 February 1973 without interest.

An existing UK settlement's trustees purchased a part share in the note on 26 February 1970 for £1,321,904.

On redemption, the trustees' share was £1,781,969. The Inland Revenue assessed the trustees on their £460,065 profit, under Schedule D Case III as a "discount" taxable under ICTA 1970 S.109(2)(b).

The Special Commissioners considered the gain capital, but the High Court (Walton J) and the Court of Appeal held that the "profit" was a taxable discount.

Walton J concluded that, with arms length parties, the three years delay in payment under the promissory note reflected compensation for delay. I.e. Celanese would have accepted less than £2,399,000 if Bergers had paid cash on 23 May 1969. Accordingly the promissory note's issue was a discounting transaction.

Walton recognised that taxing the entire discount could produce injustice, even though tax law required it. He illustrated a discounted promissory note bought at a low price by a secondary purchaser when market interest rates were high. If market interest rates fell and the note was resold, much of the investor's profit would have nothing to do with amortisation of the original discount. Nevertheless the entire profit would be taxed under Schedule D Case III. (This anomaly was addressed by the 1984 legislation discussed below).

Walton J recognised that the law taxed the trustees on the discount "as if it were a lump sum paid by way of interest" but gave no relief to the paying company. (This was also addressed in the 1984 legislation).

5.3.5.3. Increase in zero coupon bonds issuance

In the years before Ditchfield v Sharp came to court, many major foreign companies issued zero coupon bonds to raise finance.

UK companies could not raise finance in the same way, since UK tax law gave no corporate deduction for the discount, either year by year, or on redemption. The investor's tax position was also unclear.

Some tax advisers proposed investing in the available foreign zero coupon bonds to achieve returns economically equivalent to interest as arguably a capital gain.

5.3.5.4. A legislative regime for zero coupon bonds

On 25 June 1982 change was announced. Legislation followed as FA 1984 S.36 and Sch.9.

- The rules covered all bonds issued at a discount of ½% for each year between issue and redemption, or exceeding 15%.

- Holders were taxed on discount actuarially accruing during their ownership, charged when the bond was transferred or redeemed.

- Issuers received an accruals basis corporate tax deduction, except for cases obviously likely to lead to a loss of tax such as bonds held by associated companies. The government clearly accepted the general mismatch from corporate issuers receiving an accruals basis deduction with investors only taxed on realisation.

- Gains apart from the accruing discount remained capital gains.

Overall, the 1984 legislation provided a workable basis for issuers and investors.

5.3.5.5. Legislation to counter synthetic stripping

Parliament quickly found anti-avoidance legislation necessary to counter synthetic gilt stripping discussed in section 6.4.1.

FA 1985 Sch.11 para.1 & 2 introduced what is now ICTA 1988 Sch.4 para.2 & 3 with an annual tax charge on investors by deeming income to arise at the end of each income period equal to the linked income element. It applied to corporate deep discount bonds if at least 75% of the issuer's assets were "relevant securities" as defined.

The Government's concern was that otherwise investors would have no tax liability until bond disposal. Meanwhile, the issuer could offset its accruals basis deduction in respect of the discount against the interest income arising on its portfolio of securities. There would be an overall reduction in aggregate tax revenue.

The legislation succeeded in preventing the development of synthetic gilt stripping in the UK.

5.3.6. Puttable bonds

The deep discount bonds legislation only compared issue price and redemption value to identify an issue discount. ICTA 1988 Sch.4 para.1(1)(c)

A simple example escaping the provisions would be a bond with £100 face value, interest £7pa, issued at £100, with a holder "put option" to require the company to purchase the bond at £105 after 3 years.

Such put options are often granted for commercial reasons, e.g. to protect investors if there is a change in control of the issuer. Equally one can envisage tax avoidance if investors were not taxable on the gain.

Accordingly, FA 1989 Sch.11 introduced provisions to charge such "deep gains", with complex exemptions such as "qualifying indexed securities".

5.3.7. Accounting for discounts

The writer regards Willingale v International Commercial Bank Ltd, 52 TC 242 as a high watermark for taxation ignoring commercial reality.

The bank provided international trade finance by discounting trade bills and promissory notes, and also purchased such instruments in the secondary market. Once acquired, they were usually held until maturity.

The bank's statutory accounts recorded its holdings of bills at cost plus accrued discount, apportioned on a straight-line basis over the bills' lives. The bank's corporation tax returns excluded accrued discount from taxable income, recognising no taxable income until a bill was sold or matured.

The House of Lords accepted that the tax returns were properly prepared. They gave the following reasons:

- The bank's auditors testified that, if the bank's statutory accounts had used the tax returns' basis, they would have accepted them as giving a true and fair view. Accordingly, both "accrual of discount" and "non-accrual of discount" represented acceptable implementations of the normal principles of commercial accounting.

- Lord Fraser (on page 273) did not accept that (in the words of Stamp L.J.) "*there is no distinction in principle between earning interest and earning discount*". He considered that, although interest accrues from day to day, discount does not.

The writer regards the House wrong in not recognising the equivalence of discount and interest.

Lord Fraser stressed that the discount was not realised until sale or maturity. However, it is tolerably clear that if the bills had borne explicit interest, albeit compounded and payable only on maturity, then the Lords would have found against the bank. The form of the transactions as discount rather than interest determined the judgement.

5.3.8. Deferral of interest receipts

Another "mischief" was UK companies making loans to foreign affiliates, with interest income accrued by the UK company, but not currently received. The simplest approach was the foreign affiliate issuing a zero coupon bond. Other arrangements involved loans exempted from the deep gains charge in FA 1989 Sch.11.

The Inland Revenue often contended that such Schedule D case IV/V income was taxable as it accrued, but conceded in correspondence that such an interpretation of the "arising basis" was incorrect.

Accordingly, FA 1993 S.61-66 followed, creating an annual tax charge by deeming the security to be transferred at each year-end of the UK holder, and overriding the exemptions in FA 1989 Sch.11.

5.3.9. Zero coupon bonds held by associates of banks

Banks themselves as financial traders had always recognised deep discount income currently under Schedule D case I trading principles. However, they had simply arranged for any deep discount bond investments to be held by investment company subsidiaries.

Legislation was necessary (from the Government's perspective) as banks were using such investment company subsidiaries to channel long term loans in deep discount form. Typically, a combination of a set of deep discount bonds with a series of redemption dates plus a "fixed to floating" interest rate swap gave the borrower the equivalent of a long term amortising loan at floating interest rates. Meanwhile the bank's subsidiary was not taxed on the related loan income until each tranche of deep discount bond matured.

FA 1995 S.88 made some minor drafting changes to FA1993 S.63-66. This enabled FA 1995 S.89 to extend the application of the rules to debts of that kind held by companies associated with banks,

using the association test of ICTA 1988 S.416. The effect was to create a current period tax charge on income that otherwise would not be taxed until the debt was redeemed or transferred.

5.3.10. Equity linked loan stock as a QCB

The deep gains legislation in FA 1989 Sch.11 para.2(2)(c) exempted securities linked to a stock market index. Accordingly, it was possible to structure a loan that:

- fell outside FA 1989 Sch.11 to avoid income tax
- was also structured to be a QCB and therefore exempt from capital gains tax.

The first public use of this "anomaly" came in November 1994. A new investment trust, Fidelity Special Values plc issued loan stock that was linked to the value of the All Share Index. The promotional materials made clear that the loan stock had been designed to be exempt from capital gains tax.

Legislative counteraction was immediate in the Budget on 29th November, which announced what is now FA 1995 S.50. That provision amended the definition of a QCB in TCGA 1992 S.117 to ensure that for all disposals after Budget day a quoted indexed security falling within FA 1989 Sch.11 para.2(2)(c) would not be treated as a QCB.

5.4. The position by 25 May 1995

By the first announcement of the new rules, the relevant law was a mess. Lots of complex legislation had been passed piecemeal to deal with new commercial practices and to close perceived avoidance opportunities.

5.5. Defects in the tax system

Tax law relating to debts and interest had major defects. These were additional to its inability to deal with gilt stripping.

5.5.1. From Inland Revenue perspective

The law failed to tax certain economic gains, while other gains were taxed on a “realisation basis”. Some of the many anomalies were:

- There was no taxation of the discount on low coupon gilts, even though this was economically equivalent to interest.
- Corporate bonds purchased in the secondary market below face value and held until maturity or sold at a profit gave rise to no taxable income (apart from the interest coupon).
- The discount on a zero coupon bond was taxable only on disposal, while the issuer received an accruals basis tax deduction.
- There was no taxation of economic gains arising from changes in the market value of a zero coupon bond. The only item taxed on disposal was the accruing discount.

5.5.2. From taxpayer perspective

The system was also unfair to taxpayers:

A DETAILED REVIEW OF THE NEW UK TAX RULES ON CORPORATE DEBT

- Investors in bonds received no tax relief for losses (even when realised) arising from either market fluctuations or declines in the borrowers creditworthiness.

- The issuing company received no tax relief for “deep gains” even though investors were taxed.

- No tax relief was given for the costs of obtaining release from onerous loans. Many companies paid penalties to their bank lenders or premiums to their bondholders of tens of millions of pounds and obtained no tax relief e.g. when the privatised utilities redeemed, at a premium, high interest bonds held by the government.

6. Stripping Government Bonds

6.1. Purpose

The primary rationale for the new corporate debt rules was to enable the introduction of a gilt strips market. Accordingly, this chapter discusses the financial background.

6.2. Fundamental concepts of debt instruments

The underlying concepts are most easily explained with an illustration. This is based upon a hypothetical government bond and a set of assumed market circumstances on 1 January 1998.

6.2.1. The Yield Curve

The “Financial Times” for 12 September 1997 gave the following interest rates quoted from the previous day’s inter-bank sterling market:

Time period	% rate required on loans “LIBOR”		% rate offered on deposits “LIBID”	
Overnight	$7\frac{1}{32}$	7.03125	$6\frac{1}{2}$	6.50000
7 days notice	$7\frac{1}{16}$	7.06250	$6\frac{7}{8}$	6.87500
One month	$7\frac{1}{8}$	7.12500	7	7.00000
Three months	$7\frac{9}{32}$	7.28125	$7\frac{5}{32}$	7.15625
Six months	$7\frac{13}{32}$	7.40625	$7\frac{9}{32}$	7.28125
One year	$7\frac{9}{16}$	7.56250	$7\frac{7}{16}$	7.43750

The “Financial Times” quoted the fractions given above. The writer has converted them into decimals for comparison.

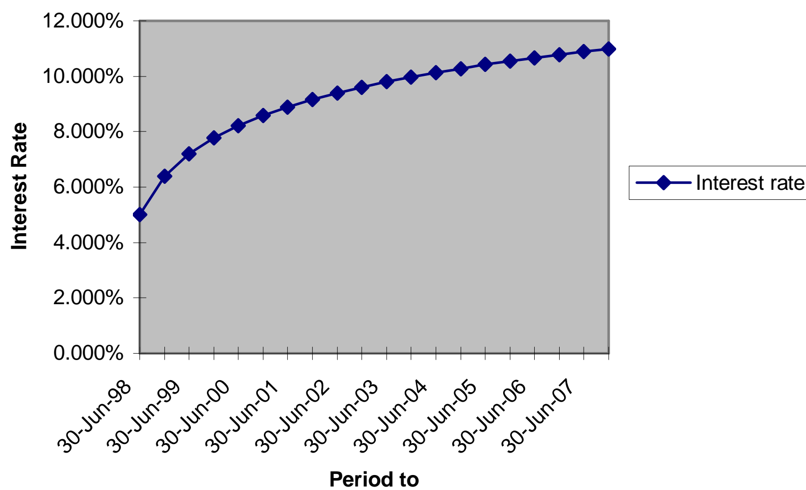
A graph of interest rates against time periods is referred to as a “yield curve”.

The table and graph following illustrate a yield curve on 1 January 1998. For convenience of exposition, all of the interest rates shown are hypothetical.

Table 1

Period from 1.1.98 to:	Interest rate
30-Jun-98	5.000%
31-Dec-98	6.390%
30-Jun-99	7.200%
31-Dec-99	7.770%
30-Jun-00	8.220%
31-Dec-00	8.580%
30-Jun-01	8.890%
31-Dec-01	9.160%
30-Jun-02	9.390%
31-Dec-02	9.610%
30-Jun-03	9.800%
31-Dec-03	9.970%
30-Jun-04	10.130%
31-Dec-04	10.280%
30-Jun-05	10.420%
31-Dec-05	10.550%
30-Jun-06	10.670%
31-Dec-06	10.780%
30-Jun-07	10.890%
31-Dec-07	10.990%

Yield Curve on 1 January 1998



This yield curve shown is one for deposits repayable with all accumulated interest in one single payment. Practitioners refer to such interest rates as “zero coupon spot rates.” This precise formulation facilitates later computations.

6.2.2. Conversions between six monthly and annual interest rates

The writer's convention is that all interest rates are based upon six monthly periods and then doubled to quote an annual rate.

E.g. the interest rate for six months to 30 June 1998 is 2.5%, and this is referred to as 5% pa. [Strictly 2.5% every six months would compound to 5.0625%]. Similarly, the quoted rate of 6.39% for the 12 months to 31 December 1998 is taken to mean 3.195% (i.e. half of 6.39%) every six months.

This convention is used purely for convenience. Using strict conversions from six monthly to annual rates would make the calculations slightly harder to follow without changing any of the principles.

6.2.3. Bond Yields

Consider a hypothetical 10-year 7% government bond issued on 1 January 1998. On each £100 bond, the investor will receive £3.50 interest (assumed to be paid gross) every six months commencing 30 June 1998, with the last interest payment due on 31 December 2007. On 31 December 2007 the bond will be redeemed at its face value of £100.

As the table shows, given the hypothetical yield curve prevailing on 1 January 1998, the bond would be issued at a price of £78.33 for £100 of face value.

For convenience the writer's tables only show monetary values to two decimal places. The underlying calculations are more accurate.

Table 2

Period from 1.1.98 to:	Interest rate	Periodic rate	Number of periods	Cash payment	NPV
30-Jun-98	5.000%	2.500%	1	£3.50	£3.41
31-Dec-98	6.390%	3.195%	2	£3.50	£3.29
30-Jun-99	7.200%	3.600%	3	£3.50	£3.15
31-Dec-99	7.770%	3.885%	4	£3.50	£3.01
30-Jun-00	8.220%	4.110%	5	£3.50	£2.86
31-Dec-00	8.580%	4.290%	6	£3.50	£2.72
30-Jun-01	8.890%	4.445%	7	£3.50	£2.58
31-Dec-01	9.160%	4.580%	8	£3.50	£2.45
30-Jun-02	9.390%	4.695%	9	£3.50	£2.32
31-Dec-02	9.610%	4.805%	10	£3.50	£2.19
30-Jun-03	9.800%	4.900%	11	£3.50	£2.07
31-Dec-03	9.970%	4.985%	12	£3.50	£1.95
30-Jun-04	10.130%	5.065%	13	£3.50	£1.84
31-Dec-04	10.280%	5.140%	14	£3.50	£1.74
30-Jun-05	10.420%	5.210%	15	£3.50	£1.63
31-Dec-05	10.550%	5.275%	16	£3.50	£1.54
30-Jun-06	10.670%	5.335%	17	£3.50	£1.45
31-Dec-06	10.780%	5.390%	18	£3.50	£1.36
30-Jun-07	10.890%	5.445%	19	£3.50	£1.28
31-Dec-07	10.990%	5.495%	20	£103.50	£35.51
					£78.33

The "Financial Times" would quote two items as well as the price of £78.33.

6.2.3.1. The Running Yield

This is the nominal interest rate (7%) divided by the price (£78.33), i.e. 8.94%.

This figure does not give the full return from the bond, since it ignores the gain from receiving repayment of £100 for a purchase price of £78.33.

6.2.3.2. The Yield to Maturity

This is the rate which, when used to discount the future bond receipts, gives a net present value equal to the current market price.

Internal rate of return of bond cash flows	**5.28%**
Date of event	**Bond cash flows**
1-Jan-98	(£78.33)
30-Jun-98	£3.50
31-Dec-98	£3.50
30-Jun-99	£3.50
31-Dec-99	£3.50
30-Jun-00	£3.50
31-Dec-00	£3.50
30-Jun-01	£3.50
31-Dec-01	£3.50
30-Jun-02	£3.50
31-Dec-02	£3.50
30-Jun-03	£3.50
31-Dec-03	£3.50
30-Jun-04	£3.50
31-Dec-04	£3.50
30-Jun-05	£3.50
31-Dec-05	£3.50
30-Jun-06	£3.50
31-Dec-06	£3.50
30-Jun-07	£3.50
31-Dec-07	£103.50

The yield to maturity is 5.281% every six months, i.e. 10.561%pa.

This one number compares the total return from the bond (£3.50 interest paid every six months and the redemption payment of £100) with the purchase price of £78.33.

6.2.4. Re-investment Risk

Consider an investor (e.g. a pensions company committed to future pension payments) who will require £100 on 31 December 2007 and wishes to ensure, by immediately investing in a bond, that it will have the cash available.

Purchasing £100 face value of bond for £78.33 would guarantee £100 on 31 December 2007. However, it also generates interest receipts of £3.50 every six months, which are superfluous. The investor's initial outlay would be too high.

Alternatively it could purchase fewer bonds now, and re-invest each interest coupon received.

If the yield to maturity remains constant at 10.561% pa over the bond's life 10-year life (not realistic in practice) then its future market price will be:

Date	Bond price
1-Jan-98	£78.33
30-Jun-98	£78.96
31-Dec-98	£79.63
30-Jun-99	£80.34
31-Dec-99	£81.08
30-Jun-00	£81.86
31-Dec-00	£82.69
30-Jun-01	£83.55
31-Dec-01	£84.46
30-Jun-02	£85.42
31-Dec-02	£86.44
30-Jun-03	£87.50
31-Dec-03	£88.62
30-Jun-04	£89.80
31-Dec-04	£91.04
30-Jun-05	£92.35
31-Dec-05	£93.73
30-Jun-06	£95.18
31-Dec-06	£96.70
30-Jun-07	£98.31
31-Dec-07	£100.00

The table below illustrates the re-investment strategy. The investor spends £35.73 on bonds on 1 January 1998, and reinvests all future interest receipts. It will have exactly £100 on 31 December 2007 as required.

Period Start	Period End	Bond price	Investment of principal and interest	Face value acquired	Cumulative face value owned	Interest receipt at period end
1-Jan-98	30-Jun-98	£78.33	£35.73	£45.62	£45.62	£1.60
30-Jun-98	31-Dec-98	£78.96	£1.60	£2.02	£47.64	£1.67
31-Dec-98	30-Jun-99	£79.63	£1.67	£2.09	£49.73	£1.74
30-Jun-99	31-Dec-99	£80.34	£1.74	£2.17	£51.90	£1.82
31-Dec-99	30-Jun-00	£81.08	£1.82	£2.24	£54.14	£1.89
30-Jun-00	31-Dec-00	£81.86	£1.89	£2.31	£56.45	£1.98
31-Dec-00	30-Jun-01	£82.69	£1.98	£2.39	£58.84	£2.06
30-Jun-01	31-Dec-01	£83.55	£2.06	£2.46	£61.31	£2.15
31-Dec-01	30-Jun-02	£84.46	£2.15	£2.54	£63.85	£2.23
30-Jun-02	31-Dec-02	£85.42	£2.23	£2.62	£66.46	£2.33
31-Dec-02	30-Jun-03	£86.44	£2.33	£2.69	£69.16	£2.42
30-Jun-03	31-Dec-03	£87.50	£2.42	£2.77	£71.92	£2.52
31-Dec-03	30-Jun-04	£88.62	£2.52	£2.84	£74.76	£2.62
30-Jun-04	31-Dec-04	£89.80	£2.62	£2.91	£77.68	£2.72
31-Dec-04	30-Jun-05	£91.04	£2.72	£2.99	£80.66	£2.82
30-Jun-05	31-Dec-05	£92.35	£2.82	£3.06	£83.72	£2.93
31-Dec-05	30-Jun-06	£93.73	£2.93	£3.13	£86.85	£3.04
30-Jun-06	31-Dec-06	£95.18	£3.04	£3.19	£90.04	£3.15
31-Dec-06	30-Jun-07	£96.70	£3.15	£3.26	£93.30	£3.27
30-Jun-07	31-Dec-07	£98.31	£3.27	£3.32	£96.62	£3.38

Total cash received on redemption day

Redemption of bond holding at face value	£96.62
Final interest payment	£3.38
	£100.00

This strategy is critically dependent upon the assumption that the yield to maturity of the bond never changes over this 10-year period; i.e. future prices are exactly as given above.

In practice, interest rates and bond prices change all the time. Accordingly the bond investor cannot be sure that starting with £35.73 he will be able to accumulate £100 by 31 December 2007.

This uncertainty is called "reinvestment risk" because the investor cannot be sure that he will be able to re-invest his future interest receipts at the yield originally hoped for.

6.2.5. Zero coupon bonds

A zero coupon bond is just that, a bond paying no interest.

As indicated by the yield curve detailed on page 27, 10.99% would be the appropriate interest rate for a 10-year zero coupon bond issued on 1 January 1998. The market value or issue price of a £100 face value zero coupon bond is calculated as follows:

$$\text{Market Value} = £34.30 = \frac{£100}{(1+0.1099/2)^{20}}$$

6.2.5.1. Attractions for a long term holder

There is no longer any reinvestment risk arising from future fluctuations in interest rates.

E.g. if the current date is 1 January 1998 and the investor needs £100 on 31 December 2007, he knows that by investing £34.30 in a zero coupon bond, exactly £100 will be received on 31 December 2007.

6.2.5.2. Attractions for short term speculative holders

Bond prices fluctuate with interest rate changes. The further in the future the bond's cash flows, the greater the fluctuation.

Consider two alternative bonds:

Coupon bond

Consider the hypothetical bond discussed on page 28. As shown on page 28, with the yield curve assumed, the market value of the regular bond will be £78.33.

If the entire yield curve is shifted upwards by one per cent, the value of the regular bond will fall from £78.33 to £73.46 as calculated below:

1.000% Rate uplift

Period from 1.1.98 to:	Uplifted rate	Periodic rate	Number of periods	Cash payment	NPV
30-Jun-98	6.000%	3.000%	1	£3.50	£3.40
31-Dec-98	7.390%	3.695%	2	£3.50	£3.26
30-Jun-99	8.200%	4.100%	3	£3.50	£3.10
31-Dec-99	8.770%	4.385%	4	£3.50	£2.95
30-Jun-00	9.220%	4.610%	5	£3.50	£2.79
31-Dec-00	9.580%	4.790%	6	£3.50	£2.64
30-Jun-01	9.890%	4.945%	7	£3.50	£2.50
31-Dec-01	10.160%	5.080%	8	£3.50	£2.35
30-Jun-02	10.390%	5.195%	9	£3.50	£2.22
31-Dec-02	10.610%	5.305%	10	£3.50	£2.09
30-Jun-03	10.800%	5.400%	11	£3.50	£1.96
31-Dec-03	10.970%	5.485%	12	£3.50	£1.84
30-Jun-04	11.130%	5.565%	13	£3.50	£1.73
31-Dec-04	11.280%	5.640%	14	£3.50	£1.62
30-Jun-05	11.420%	5.710%	15	£3.50	£1.52
31-Dec-05	11.550%	5.775%	16	£3.50	£1.43
30-Jun-06	11.670%	5.835%	17	£3.50	£1.33
31-Dec-06	11.780%	5.890%	18	£3.50	£1.25
30-Jun-07	11.890%	5.945%	19	£3.50	£1.17
31-Dec-07	11.990%	5.995%	20	£103.50	£32.30
					£73.46

I.e. the coupon bond will fall in value by 6.21% of its value.

Zero coupon bond

This has only a single redemption payment of £100 on 31 December 2007. The market on 1 January 1998 will be £34.30 as calculated on page 31.

When the entire yield curve is shifted upwards by 1%, the applicable interest rate becomes 11.99% and the value of the zero coupon bond will fall from £34.30 to £31.21, a loss of 9.02% of its value.

The decline in value significantly exceeds that of the coupon bond.

Similarly, if interest rates fell, the zero coupon bond would rise in market value more than the coupon bond.

Accordingly, zero coupon bonds are an attractive medium to speculate on the movement of long-term interest rates. The writer has previously held them for this purpose.

6.2.5.3. Attractions for an issuing company

Zero coupon bonds can be attractive to fund a capital project which may not generate cash returns for some time, as they avoid the burden of intervening cash interest payments.

The attraction rises when the tax system gives annual tax relief for the discount amortisation even though no cash is paid out until the bond is redeemed.

Since 1984, there has been a gradual increase in zero coupon bond issuance by major UK companies such as British Telecommunications plc.

6.2.5.4. Attractiveness or otherwise for issuing governments

Governments find few reasons for zero coupon bond issuance:

- Unlike companies, governments are not constrained by the availability of cash.
- The bond interest has the same impact in the public expenditure accounts regardless of whether it is paid out or not.
- Governments are not seeking tax relief on the interest amortisation.

Accordingly, although governments (e.g. Lower Saxony) have issued zero coupon bonds, it is relatively rare.

6.3. What is stripping?

Historically, investor demand for zero coupon bonds has exceeded supply. In particular, the issuers whose bonds are safest, governments, have tended not to issue zero coupon bonds. This demand encouraged intermediaries to convert coupon bonds into zero coupon bonds.

Consider the bond illustrated on page 28. An investment bank could purchase this bond in the market for £78.33 for each £100 of face value. Each £100 bond then gives rise to 20 specific future cash flows. I.e. £3.50 payable each 30 June and 31 December, culminating in a final £103.50 payable on 31 December 2007.

Each of these 20 future cash entitlements could be sold, separately, to different investors. For example, the £3.50 due on 31 December 2005 would sell on 1 January 1998 for approximately £1.54.

Given market demand, the investment bank might be able to sell the 20 separate receipts for aggregate sales prices exceeding its purchase price of £78.33, this excess representing its profit. The profit arises from the demand for zero coupon bonds exceeding the readily available supply.

In the USA, as the market developed, the term "STRIPS" was employed to stand for Separate Trading of Registered Interest and Principal Securities.[2] The name vividly represents each individual cash flow being peeled or "stripped" away (like bearer bond interest coupons) from the bond and sold separately.

6.4. Alternative stripping methods

There are two fundamentally different ways.

6.4.1. “Synthetic” stripping

An investment bank purchases a bond. The investment bank then sells new, original, zero coupon obligations of its own, with a liability profile matching that of the regular (coupon) bond owned by the bank.

For example, having purchased the £100 face value hypothetical bond mentioned on page 28, the investment bank could issue, inter alia, a £3.50 face value zero coupon bond repayable on 31 December, 2005, achieving an approximate issue price of £1.54. The bank is certain that it can meet the £3.50 obligation when due on 31 December 2005 since it owns a regular bond, which will supply the required cash.

From the investor's perspective, a zero coupon bond issued by an investment bank carries a significantly higher credit risk than the underlying regular bond.

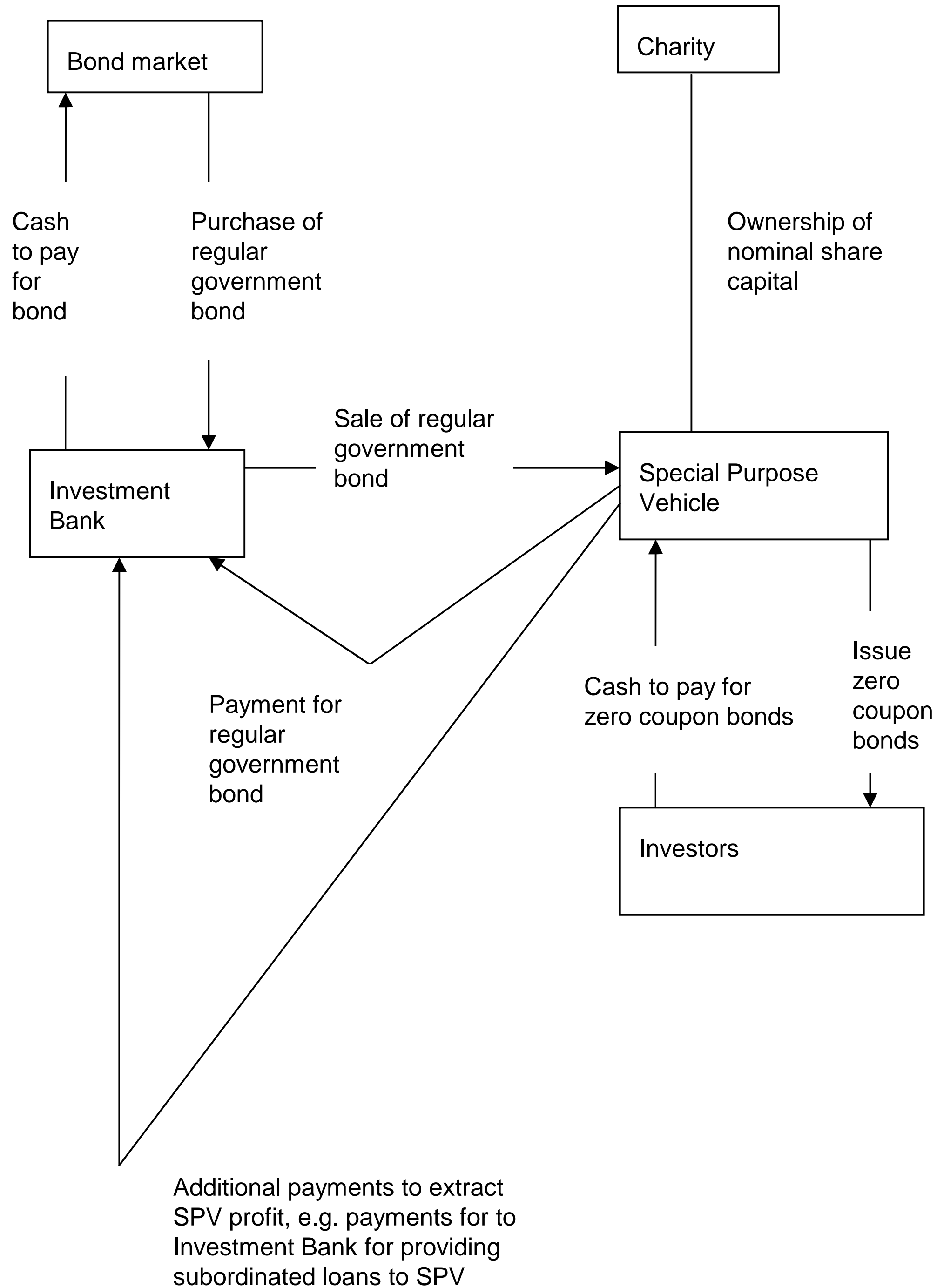
For example, if the UK government issues the underlying regular bond, it is traditionally regarded as risk free. However, while the investment bank holds a risk free asset, its matching zero coupon bond is not a risk free asset to the investor. If the investment bank becomes insolvent, the zero coupon bond investor may receive only a rateable share (alongside other creditors) of the insolvent investment bank's assets.

The investment bank could secure its zero coupon bonds by a legal mortgage over the regular (government) bond. This reduces the riskiness of the investment bank’s zero coupon bonds, but does not make them risk free as such a legal mortgage might prove insufficient. E.g. on insolvency certain obligations of the bank will rank ahead of a legal mortgage.

To make the secondary zero coupon bonds more secure, they could (and in practice typically would) be issued by a "special purpose vehicle" (SPV).

An SPV is a company carrying on no other activities, with no other assets or liabilities. This ensures that the assets of the SPV (being the regular government bond) are fully available to meet its liabilities (being the zero coupon bonds issued by it.) The investment bank would not own the SPV, to isolate it from the investment bank's creditors. A typical structure is illustrated on the next page:

An illustrative structure for indirect stripping using a Special Purpose Vehicle (SPV)



The principal drawbacks of synthetic stripping are:

- Even with the SPV, the credit rating of the zero coupon bonds issued will still be lower than that of government debt. The zero coupon bonds will not be free from all default risk.

- The credit enhancement measures illustrated all involve additional complexity, initial costs for setting up the structure and annual costs to operate it.

However, synthetic stripping is all that is available unless a government facilitates "direct" stripping. Until the recent changes to the UK government bond market, UK government bonds could only be stripped "synthetically." Furthermore, the tax system actively sought to discourage stripping as discussed in section 5.3.5.5.

6.4.2. “Direct” stripping

The issuing government facilitates the separation of the interest coupons (i.e. the £3.50 payable every six months) and the principal repayment (i.e. the final £100 redemption) into separate registered government securities. Critically, each separate payment, i.e. each strip, remains a direct obligation of the government.

Accordingly, stripping takes a risk free government coupon bond and converts it into a collection of equally risk free zero coupon bonds. The separation process requires nothing more than book entries in the government stocks register.

The stripping process should be reversible to ensure arbitrage prevents the prices of coupon gilts and gilt strips getting "out of line" with each other.

I.e. by separately purchasing the 20 interest coupons and the principal payment due under our hypothetical gilt (assuming it had been stripped) the investor would have acquired all the rights of the original coupon bond. Accordingly, he could ask the stock’s registrar to reconstitute this into a coupon bond capable of sale as such.

To summarise, direct stripping is preferable to synthetic stripping because:

- It maintains the risk free nature of the government bond, rather than introducing new credit risk.

- The administrative costs should be much lower, as special purpose vehicles are not required.

- The process can be made readily reversible, unlike synthetic stripping, where reversal would be as complex as the original stripping exercise.

Accordingly, if the government considers stripping desirable, then it should facilitate direct stripping.

6.5. Why facilitate stripping?

The rate of interest that the government must pay on new borrowings is determined by the price that investors will pay to acquire new government bonds offering particular future cash flows.

Our discussion of stripping on page 34 explains why investors might be willing to pay slightly more to purchase zero coupon bonds whose cash flow profile exactly matches their requirements. In that example, the investment bank conducting the synthetic stripping captured the profit (i.e. the excess value of the future payments sold individually over the price of the coupon bond.)

If however government bonds can be stripped directly (and reversibly) then such a pricing anomaly cannot exist due to arbitrage. The overall price of coupon gilts must rise slightly until it equals the

price that investors are willing to pay in aggregate, for the future cash flows they require. This higher price at which government bonds can be issued reduces government funding costs.

Press estimates in May 1995 suggested that improvements in gilt market operations could reduce aggregate government borrowing costs by up to 0.5% pa. On 1 October 1997 there were £78 billion of strippable gilts outstanding.[3] Using 0.5% pa the writer estimates the benefit to the government, once fully reflected in borrowing costs, at about £400 million per year.

7. How the New System Operates

7.1. New words and phrases

New terminology (e.g. loan relationships, credits and debits) is used to avoid phraseology that is encumbered with past interpretations.

7.2. Who is within the new system?

7.2.1. In full

The new legislation applies to companies that are subject to corporation tax. S.80(1)

Under S.80(5) the charge under the loan relationship rules is exclusive for corporation tax purposes. As part of achieving exclusiveness, S.79 abolishes the charge under schedule C in respect of public revenue interest, and replaces that with a charge to schedule D.

7.2.2. In part

Individuals and other income tax payers (e.g. overseas companies deriving rental income from the UK) are affected to a limited extent, as specified by S.102 and Sch.13. See section 7.19 of this thesis.

7.3. What assets/liabilities are within the system?

The new regime applies to assets and liabilities that are “loan relationships.”

7.3.1. Basic definition of a loan relationship

A company has a loan relationship when it is a debtor/creditor in respect of a money debt (defined in S.81(2)) and that debt arises from the lending of money. S.81(1)

7.3.1.1. Debts which are not money debts

An obligation to deliver a tangible asset is not a money debt. E.g. a company receives cash in exchange for a promise to deliver steel the following week. The company’s liability does not fall to be settled in money and is not a money debt.

7.3.1.2. Money debts which are not loan relationships

An example is unpaid purchase consideration. A company may purchase land in exchange for the promise to pay money the following week. The company's liability is a money debt, but not arising from the lending of money. Accordingly it is not a loan relationship.

7.3.1.3. Shares in a company

Under S.81(4) a debt arising from rights conferred by company shares is taken not to arise from lending money. A simple example is an unpaid dividend. After the dividend has been declared, the shareholder has an enforceable money debt owed by the company, but this is not a loan relationship.

"Share" in S.103(1) means a share "*under which an entitlement to receive distributions may arise.*" Building society permanent interest bearing shares (PIBS) generate interest, not distributions, ICTA 1988 S.349(3A). However the Inland Revenue Manual[4] at CT12119 classifies PIBS as not being loan relationships. The writer concurs since the rights of a PIBS holder are materially different from those of a normal creditor.

7.3.1.4. Implications of the issue of an instrument

S.81(3) means that a money debt that is not inherently a loan relationship (because the debt does not arise from the lending of money) can be transformed into one by the issue of an instrument.

A simple example would be where a company owing unpaid purchase consideration for land issues tradable loan notes in respect of its liability. The legislation then deems the debt to have arisen from the lending of money. Since one then has a money debt arising (by statutory hypothesis) from the lending of money, one has a loan relationship.

A promissory note does not constitute an instrument for this purpose, presumably because it lacks sufficient legal substance by itself. "*Whether promissory notes are covered by the new rules depends on whether there is a loan of money.* [Writer - if there is, the question is irrelevant!] *If there is, the promissory note is covered; if there is not, then it is not.*" Hansard Standing Committee E, 19'th sitting 29 February 1996.

7.3.2. Convertible assets

A special treatment is applied to convertible securities in S.92. The only amounts brought into account under the loan relationship rules by the creditor are "amounts relating to interest."

This section merits detailed consideration as it facilitated a widely used tax avoidance scheme.

7.3.2.1. Detailed S.92(1) requirements to qualify as a convertible security

For brevity, the legislative extracts below are abridged.

a) The asset must represent a creditor relationship

The section applies only to the company that owns the asset. The treatment of creditors and debtors is asymmetrical.

(b) The company is entitled to acquire any shares

The scope is much wider than just bonds convertible into shares of the issuer. The acquirable shares may be in any company, and it is not necessary for the bond to be explicitly converted.

Some illustrations:

- Investing company holds a £1,000 face value bond convertible at any time into 100 shares of the debtor.
- Investor owns a £1,000 "exchangeable" bond issued by company A. After 1 January 2001 the holder may surrender the bond back to company A in exchange for 100 shares of company B. (Typically company A desires to monetise its shareholding in company B without an immediate sale.)
- Investor owns a £1,000 bond, which has an attached warrant to subscribe, at any time, for 100 new shares of company A at a fixed price of £10 per share. Often such warrants are detachable

from the bond and tradable separately. S.92 would appear applicable to the bond only while the warrants are attached. Detaching the warrants should be a reorganisation event under TCGA 1992 S.116, with the convertible being the old asset, while the detached warrant (a chargeable asset) and the non-convertible bond (a QCB post warrant detachment) being the new assets.

(c) A "cash value" is not used to determine the extent to which shares may be acquired

The value of a convertible security should depend partly on the value of the underlying share.

This provision counters an attempt to dress up a security as a convertible while avoiding any economic linkage with the underlying share. E.g. it disqualifies a £1,000 bond convertible into whatever number of shares at the conversion date have a market value of £1,000.

(d) The asset is not a relevant discounted security

The definition of "relevant discounted security" is discussed in detail on page 76. It was possible to create a discounted bond that avoided being a relevant discounted security. E.g.:

- Bond issued on 1 January 1999, issue price of £68.
- Issuer required to redeem the bond on 31 December 2003 at £100. (Implied yield approximately 8% pa.)
- During only the seven days commencing 1 July 1999, the holder may require redemption at £68.

This bond is not a relevant discounted security. At the earliest date that the holder can require repayment, 1 July 1999, no deep gain arises.

There were other more complex (but less artificial) variants to avoid relevant discounted security classification.

(e) On issue there is more than negligible likelihood of conversion being exercised

This criterion has been criticised as being subjective and vague.

The writer offers the following practical test based on the economics of convertible securities.

Value:

- The bond as actually issued.
- The bond excising all conversion rights.

If those values are almost the same, (e.g. differing by less than 1%) then the conversion rights are worthless on issue date, and vice versa. If a conversion right has real value on the issue date, then the likelihood of it being exercised cannot be regarded as negligible.

A conversion right need not be "in the money" to have value. E.g. consider a £1,000 bond redeemable in 2020 and convertible into 4 shares of the company at any time until then. On issue date, the share price is £100.

To justify conversion, the share price needs to increase from £100 to £250. However there is a 20-year time horizon. The conversion right would have a material value on the issue date and should pass the S.92(1)(e) test.

(f) The asset is not a trading asset of the holder

The normal treatment of trading assets is not disturbed.

7.3.2.2. Implications of being a convertible security

7.3.2.2.1.The creditor

S.92(2) limits any income taxation of the creditor to amounts relating to interest. S.92(3) mandates using an authorised accruals method.

S.92(4) preserves the corporation tax treatment of chargeable gains. Under S.92(5) accrued interest is excluded from the capital gains computations, because it is already taxed under the loan relationship rules.

7.3.2.2.2.The debtor

There are no implications. The debtor has a normal loan relationship and can deduct any discount using an authorised accounting basis.

7.3.2.3. Opportunity for tax avoidance

The creditor / debtor asymmetry allowed a widely used tax avoidance scheme using a zero coupon convertible bond issued by one UK group member to another.

The investor was not subject to current taxation. The accruing bond discount did not constitute "interest" income. Corporation tax on chargeable gains would arise on redemption (with indexation allowance) but a chargeable disposal could be avoided by converting the security instead of redemption.

The issuer deducted the annual expense from amortising the discount over the bond life.

7.3.2.4. Legislative counteraction

An Inland Revenue press release on 15 February 1999 announced counteraction, now contained in FA 1999 S.65 which applies to transfers and disposals occurring, and to accounting periods ending on or after 15 February 1999.

Very briefly, FA1999 S.65(1) revises FA 1996 Sch.13 para.3(1) so that the deep gain test is computed on maturity as well on any earlier possible redemption date. A deep gain on any date makes the security a relevant discounted security.

- This eliminates the deduction/income mismatch for the accounting period straddling 15 February 1999 and later periods.
- It charges the previously untaxed appreciation on a future disposal.
- Because the security is now a relevant discounted security, it is also a QCB due to TCGA 1992 S.117(2AA). On conversion into shares, TCGA 1992 S.116(9) applies so that a taxable disposal arises. This ensures that the previously accrued gain cannot be avoided by conversion.

7.3.3. Loans linked to chargeable assets

FA 1996 S.93 contains special rules.

7.3.3.1. Loans held as trading assets excluded

S.93(1) excludes these from S.93 treatment. The writer considers the S.93(1) test applicable only to creditors, since one "disposes" of assets but not liabilities. Also the wording is clearly copied from S.103(2) which is applicable only to creditor relationships.

7.3.3.2. The charging and relieving provision

The credits and debits brought into account are restricted to amounts relating to interest, and authorised accruals accounting must be applied.

Where a company holds such a loan relationship as an asset, it remains within the charge to capital gains tax. S.93(5) excludes interest accruals from the capital gain calculations.

7.3.3.3. Applicable definition

The key definition is in S.93(6). The amount payable to discharge the money debt must be determined by applying a relevant percentage change in the value of chargeable assets to the original amount of the loan. S.93(7) allows an index of the value of chargeable assets to be used.

If the asset's value rises from A to B, the percentage increase is $\frac{(B-A)x100}{A}$

If P is the original amount of the loan, then for S.93(6) to be meaningful, the amount payable on redemption must be:

$$P\left[100+\frac{(B-A)x100}{A}\right]x\frac{1}{100}$$

Tolley's[8] 5.1 argues that S.93(6) is misdrafted since multiplying "P" by the percentage change gives the wrong answer and ignores the need to repay the principal. In the writer's opinion, this is not a proper reading of "*applying the percentage change*."

S.93(9) contains a limited permissible deviation from the strict application of changes in the market value of the chargeable asset. It is permissible to provide that "*the amount so payable* [on discharge of the money debt] *must not be less than a specified percentage of the amount falling for the purposes of this chapter to be regarded as the amount of the original loan*." The specified percentage cannot be more than 10%.

In the writer's view, the protection permitted by S.93(9) against downward fluctuations in the value of the chargeable asset is very limited since the highest permitted floor for the loan value is 10% of the amount of the original loan. I.e. 90% of the loan value could be lost in downward asset price fluctuations. This may not have been the intention of the legislation and, for example, the CIOT[5] annotated edition of FA1996 interprets S.93(9) as meaning that "*the amount payable cannot be less than the original loan by up to and including 10%.*" However, in the writer's view the wording of S.93(9) is relatively clear and inconsistent with the CIOT commentary. Tolley's[8] 5.21 concurs with the writer's view, as does IRLRM[4] at CT12144.

7.3.3.4. Can loans be linked to trading assets?

Surprisingly, it does not matter if a real disposal of the real asset would be trading income, eg a building owned by a property trader. S.93(10) requires the assumption in S.93(11)(b) " *the asset is not one the disposal of which by the company would fall to be treated for the purposes of corporation tax as a disposal in the course of a trade carried on by the company*."

Accordingly, S.93 is looking at the quality of the asset generally, and not its status in the hands of a particular owner.

7.3.3.5. Does S.93 have to apply symmetrically?

IRLRM[4] at CT12141 and other commentators assume that the creditor and the debtor inevitably receive symmetrical treatment. However, S.93 does not explicitly mandate symmetry.

The writer, prompted by S.93(10) "*an asset is a chargeable asset, in relation to a loan relationship of a company"*, has contemplated whether a loan relationship can be within S.93 for one party but not the other. However, due to the strong assumptions in S.93(11) the writer is unable to devise a counterexample and concludes that IRLRM is correct in assuming symmetry.

7.3.3.6. Using asset linked debt

A company can hedge its ownership risk on an asset by issuing a security linked to its value. However, the hedge is imperfect since gains on the asset are (generally) taxable, whereas the corresponding premium on repaying the asset linked debt will be non-deductible. Accordingly, the only recent issuers of public asset linked debt the writer is aware of are investment trusts issuing debt linked to equity indices. For them the hedge is effective since their chargeable gains on investments are exempt.

There may be scope for UK companies to invest in asset linked debt issued by foreign affiliates, if the overseas jurisdiction gives relief for the debt uplift. The group would benefit from indexation allowance reducing the UK taxable amount below the amount deductible overseas.

7.3.4. Index linked gilts

Special provisions are included in S.94 to maintain the previous treatment of index linked gilt-edged securities. They do not apply to securities traders holding index-linked gilts as trading stock.

Very briefly, under S.94(3) the opening value of the gilt is increased or reduced by the movement in the retail prices index between the opening date and closing date as defined in S.94(2). The indexation adjustment is applied only to the capital value; there is no adjustment to the amount of the taxable interest income.

Under the previous treatment of all gilts, interest was fully taxable but changes in capital value were not taxed. As changes in the capital value of gilts are generally now taxable, it is consistent to tax changes in the capital value of index linked gilts. However preserving exemption for the inflation uplift is fair since the interest coupon is lower than that for conventional gilts, in exchange for inflation protection.

S.94(4) permits Treasury regulations to disapply this section. Such regulations can only apply to subsequent gilt issues.

S.94(7) means only index-linked gilts allow the inflation uplift to be tax-free. Accordingly, investors in index linked securities issued by companies or by foreign governments are taxed on the entire change in money value without relief for UK or foreign inflation.

7.4. How are the loan relationship calculations made?

S.82(1) requires the company to compute the debits and credits for the accounting period. S.84(1) requires the use of an authorised accounting method. The outcome must fairly represent all of the

company's loan relationship profits, gains and losses. S.84(1)(a) overrides the revenue / capital distinction.

7.4.1. Mark to market

S.85(1)(b) authorises mark to market accounting. One calculates the "fair value" (defined in S.85(6)) of the loan relationship at each accounting period end.

The fair value of a loan relationship asset is essentially the same as its market value.

However there is a clear distinction between the fair value of a liability and its market value. Suppose that a company's credit worthiness has been impaired e.g. due to operating losses. The market value of its liabilities (which are assets of its lenders) in either the bond markets or in secondary bank debt trading may be very low. However, if the company needed to pay a third party to take over those liabilities (as required by the fair value definition) then the amount payable would be greater than the market value. The third party would have to meet the liabilities in full, whereas the low market value of the liabilities reflects the risk of default by the company.

See page 88 for parallel thinking by accountants.

S.85(4) requires payments to be allocated to the periods when due and payable. Payments should not be apportioned between periods; at each period end the accrued payment obligation is reflected in the fair value.

In Parliament on 5 March 1996 the government confirmed that companies had a free choice to embrace mark to market accounting and need not have used it before the law change.

7.4.2. Accruals accounting for loan relationships

S.85(3) gives details. Very briefly, payments are allocated to the accounting period to which they relate, irrespective of when paid or when due and payable. Payments relating to more than one period are apportioned on a just and reasonable basis. Apart from bad debts discussed on page 74 no recognition is given to market value fluctuations.

S.85(2)(c) prohibits calculating debits by reference to the value of a loan relationship asset. It does not correspondingly prohibit calculating credits by value although that would not be normal accruals practice.

Allocating payments to accounting periods is relatively straightforward if all payments are fixed. Any payment pattern can be transformed into annual debits by making the (usually reasonable) assumption of a constant implicit interest rate.

E.g. consider the following loan terms:

- £100 borrowed on 1 January 1998
- £50 repayable on 30 June 1998
- £30 repayable on 30 June 1999
- £40 repayable on 31 December 1999

One derives an implied interest rate of 7.78% per six months, strictly equivalent to 16.2% compounded annually. (Convention on page 28 not used.) With a year-end of 31 December, the debits for 1998 and 1999 are shown below.

Date	Cash flow		IRR, per six months	7.78%
1-Jan-98	100			
			Annual	
30-Jun-98	-50		rate	16.2%
31-Dec-98	0			
30-Jun-99	-30			
31-Dec-99	-40			

Six months commencing	Opening loan balance	Interest for six months	Cash repaid	Closing loan balance
1-Jan-98	100.00	7.78	50.00	57.78
30-Jun-98	57.78	4.49	0.00	62.27
31-Dec-98	62.27	4.84	30.00	37.11
30-Jun-99	37.11	2.89	40.00	0.00

Calendar year	Opening loan balance	Interest debit in accounts	Cash repaid	Closing loan balance
1998	100.00	12.27	50	62.27
1999	62.27	7.73	70.00	0.00

One needs no external data; only the assumption of a constant implied interest rate.

A more theoretical calculation uses the yield curve on 1st January, 1998, as set out on page 27.The relevant risk free interest rates are:

Period	Annually stated rate	Six monthly rate
1 January 1998 – 30 June 1998	5.000%	2.500%
1 January 1998 – 30 June 1999	7.200%	3.600%
1 January 1998 – 31 December 1999	7.770%	3.885%

The interest rate on corporate borrowing exceeds that on risk free government debt. If one assumes a constant risk premium (a reasonable approximation) then the risk premium is 8.507% pa, confirmed below:

Date	Cash flow	Risk free annual rate	Premium for risk, annual	Total annual rate	Six monthly rate	NPV of cash flows	Outflow, or year end balance	Interest for 1998
1-Jan-98	100.00					100.00		
30-Jun-98	(50.00)	5.000%	8.507%	13.507%	6.753%	(46.84)	50.00	3.16
31-Dec-98	0.00							0.00
30-Jun-99	(30.00)	7.200%	8.507%	15.707%	7.853%	(23.91)	27.81	3.90
31-Dec-99	(40.00)	7.770%	8.507%	16.277%	8.138%	(29.25)	34.20	4.95
Interest	(20.00)					-		12.01

The interest debit for 1999 will be £7.99, i.e. £20 total interest less £12.01 allocated to 1998.

In the writer's opinion, both should be acceptable as applications of an authorised accruals method. While the second is more theoretically correct, the first method is much simpler.

7.4.2.1. Dealing with uncertainty

Accruals accounting is more difficult when a party has an option to affect future payments. Sch.9 para.3 addresses this. It hypothesises at each period end that the party having an option will exercise it as (apart from taxation) then appears to be most advantageous.

A simple illustration:

- Corporate bond, issued on 1 January 1998, repayable at £100 on 31 December 2007 with interest of £7.00 payable each 31 December.
- Issue price £60. (Yield to maturity approximately 14.96% pa.)
- The issuer has the right to call (i.e. repay) the bond on 31 December 2002 at £105. If the call option is not exercised, it expires.

One calculates the following table of debits.

IRR 14.96%

Date	Cash flow	Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
01/01/98	60.00				
31/12/98	(7.00)	60.00	8.97	(7.00)	61.97
31/12/99	(7.00)	61.97	9.27	(7.00)	64.24
31/12/00	(7.00)	64.24	9.61	(7.00)	66.85
31/12/01	(7.00)	66.85	10.00	(7.00)	69.85
31/12/02	(7.00)	69.85	10.45	(7.00)	73.30
31/12/03	(7.00)	73.30	10.96	(7.00)	77.26
31/12/04	(7.00)	77.26	11.56	(7.00)	81.82
31/12/05	(7.00)	81.82	12.24	(7.00)	87.06
31/12/06	(7.00)	87.06	13.02	(7.00)	93.08
31/12/07	(107.00)	93.08	13.92	(107.00)	(0.00)

With no major changes to the yield curve by 31 December 1998, the appropriate Sch.9 para.3 assumption is that the issuer will not exercise its call option.

Assume that by 31 December 1999 interest rates have fallen. According to the prevailing yield curve, the company will be able to borrow at 5% on 31 December 2002. The next calculation shows that calling the bond on 31 December 2002 will be desirable.

5% Borrowing rate on 31.12.2002

3.66 NPV of calling the bond

	Cash flow	
31/12/02	(105.00)	Early bond redemption
31/12/03	7.00	Payment saved
31/12/04	7.00	Payment saved
31/12/05	7.00	Payment saved
31/12/06	7.00	Payment saved
31/12/07	107.00	Payment saved

Accordingly, at 31 December 1999 the main table must be re-computed assuming that the bond will be called on 31 December 2002.

One must not readjust the 1998 calculation. That year has elapsed and at 31 December 1998 it was appropriate to assume that the bond would not be called. The new table below shows a 1999 debit of £14.62, quite different from the amount originally expected above of £9.27.

IRR 23.58%

Date	Cash flow		Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
31/12/98	61.97	Accrued amount				
31/12/99	(7.00)	Bond interest payment	61.97	14.62	(7.00)	69.59
31/12/00	(7.00)	Bond interest payment	69.59	16.41	(7.00)	79.00
31/12/01	(7.00)	Bond interest payment	79.00	18.63	(7.00)	90.63
31/12/02	(112.00)	Interest & call payment	90.63	21.37	(112.00)	(0.00)

By 31 December 2000 the yield curve has shifted again. The company's expected borrowing cost at 31 December 2002 is now say 15%. The appropriate assumption at 31 December 2000 is that the bond will not be called. The table must be recomputed yet again:

IRR 13.43%

Date	Cash flow		Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
31/12/99	69.59	Accrued amount				
31/12/00	(7.00)	Bond interest payment	69.59	9.35	(7.00)	71.94
31/12/01	(7.00)	Bond interest payment	71.94	9.66	(7.00)	74.60
31/12/02	(7.00)	Bond interest payment	74.60	10.02	(7.00)	77.62
31/12/03	(7.00)	Bond interest payment	77.62	10.42	(7.00)	81.04
31/12/04	(7.00)	Bond interest payment	81.04	10.88	(7.00)	84.93
31/12/05	(7.00)	Bond interest payment	84.93	11.41	(7.00)	89.33
31/12/06	(7.00)	Bond interest payment	89.33	12.00	(7.00)	94.33
31/12/07	(107.00)	Interest & redemption payment	94.33	12.67	(107.00)	(0.00)

With Sch.9 para.3, changes in market conditions significantly affect the debits calculated, even though under an accruals method one ignores changes in the loan relationship's market value. The calculations above can be summarised:

Profit and loss account debit for year:	Computed at 31 December 1998	As revised at 31 December 1999	As revised at 31 December 2000
1998	8.97	8.97	8.97
1999	9.27	14.62	14.62
2000	9.61	16.41	9.35
2001	10.00	18.63	9.66
2002	10.45	21.37	10.02
2003	10.96	Assume bond called	10.42
2004	11.56	Assume bond called	10.88
2005	12.24	Assume bond called	11.41
2006	13.02	Assume bond called	12.00
2007	13.92	Assume bond called	12.67

In passing, with interest rate derivatives the company could "lock in" to its favourable 2002 borrowing capability on 31 December 1999. However, the purchase of such derivatives would not impact upon the loan relationship calculations themselves.

No equivalent to Sch.9 para.3 is required for mark to market methods. The fair value of the loan relationship will reflect any applicable options.

No statutory guidance is given regarding "*(apart from taxation)*" in Sch.9 para.3(2). The writer concludes that one hypothesises that the party with the option is exempt from tax. In the real world parties consider tax consequences when exercising options. However, the "*apart from taxation*" hypothesis makes Sch.9 para.3 easier to apply, since one ignores the relevant party's actual tax position. That tax position might not even be known with bonds in bearer form.

7.4.3. Selection of accounting method for loan relationships

S.86(3)(a) stipulates that a company using an authorised accounting method in its statutory accounts must use that same method for tax purposes. This reverses part of Willingale v International Commercial Bank Ltd.

Under S.86(3)(b) a company using in its statutory accounts an accounting method which "equates" to an authorised accounting method must for tax purposes use the authorised accounting method which has been equated. While the figures in the statutory accounts are adjusted to produce the corporate tax return, it is mandatory to use the equated authorised method.

7.4.3.1. Methods equating to an authorised accruals basis

Under S.86(5)(a) an accounting method purporting to allocate payments to accounting periods according to when they are taken to accrue equates to an authorised accruals basis of accounting.

7.4.3.2. Methods equating to mark to market

Under S.86(5)(b) if the accounting used produces credits and debits by reference to "a fair value" of the loan relationship at different times, and produces debits and credits relating to payments according to when they become due and payable, then it equates to an authorised mark to market basis.

S.86(6) considers "clean mark to market" accounting. This values the loan relationship at each accounting period end at a fair value, ignoring accrued interest, and allocates payments to accounting periods according to when they are taken to accrue. Such accounting equates to mark to market, not to accruals.

7.4.3.3. Mandatory use of authorised accruals in certain cases

As discussed in section 7.18.2 where the parties to a loan relationship are connected, the use of accruals accounting is mandatory.

7.4.4. Changing accounting methods

The legislation distinguishes between the inconsistent application of an accounting method and an actual change in accounting method.

7.4.4.1. Inconsistent application of accounting methods

S.89 applies where there is an inconsistency between periods in the application of an authorised accounting method.

Consider a security purchased for £50 redeemable at £100 in five years. The company applies an authorised accruals method on a straight-line basis.

After three years, the company decides to calculate on an actuarial method. The calculations are inconsistent and S.89 applies.

The relevant figures are:

	Straight Line Uplift	Straight Line Taxable Income From Uplift	Actuarial uplift	Actuarial Basis Taxable Income From Uplift	Cumulative difference in taxable income
Purchase of security	50		50.00		
Value at end of year 1	60	10.00	57.43	7.43	2.57
Value at end of year 2	70	10.00	65.97	8.54	4.03
Value at end of year 3	80	10.00	75.78	9.81	4.22
Value at end of year 4	90	10.00	87.05	11.27	2.95
Value at end of year 5	100	10.00	100.00	12.95	-

Under S.89(1) at the commencement of year 4 a balancing credit or debit arises. One assumes that the accounting method was always applied as in year 4. From the table above, after three years the straight-line approach has resulted in £4.22 more taxable income than the actuarial method. Accordingly, £4.22 must be deducted from the year 4 income of £11.27 to leave £7.05 chargeable.

Without S.89, over the five years the company would have been taxed on more than its economic gain.

7.4.4.2. Changes of accounting method

The principal goal of S.90 is to ensure that no debits or credits fall out of taxation.

If the new accounting method applies from the start of an accounting period, all of the computational adjustments discussed below are, under S.90(3) applied then. There is no restatement of prior period results.

On change during an accounting period, under S.90(2) the rules are applied as if the period of change were subdivided into two accounting periods. The debits and credits thereby calculated are brought into account in the (true single) period of change.

S.90 is illustrated numerically assuming:

	Fair Value of Security	Mark to Market Basis Taxable Income	Actuarial uplift	Actuarial Basis Taxable Income From Uplift
Purchase of security	50.00		50.00	
Value at end of year 1	45.00	(5.00)	57.43	7.43
Value at end of year 2	60.00	15.00	65.97	8.54
Value at end of year 3	73.00	13.00	75.78	9.81
Value at end of year 4	86.00	13.00	87.05	11.27
Value at end of year 5	100.00	14.00	100.00	12.95

Change from authorised accruals method (years 1-3) to mark to market at start of year 4

Under S.90(3)(a)(i) compute the aggregate credits and debits for years 3 and 4 making the S.90(4) assumption of disposal at the end of year 3 and reacquisition at the commencement of year 4. (Credits / debits are treated as positive / negative.) The credit for year 3, applying the accruals method but with the assumption regarding disposal, becomes 7.03. (Deemed disposal for 73.00, opening actuarial value 65.97) The credit for year 4 is 13.00. (Deemed acquisition for 73.00, closing market value 86.00) The aggregate credits are 7.03 + 13.00 = 20.03.

Under S.90(3)(a)(ii) compute the aggregate credits and debits for years 3 and 4 without the disposal assumption in 90(4). These are 9.81 for year 3 (actuarial method) and 13.00 for year 4 (mark to market method.) 9.81 + 13.00 = 22.81.

Under S.90(3)(a)(iii) subtract the second aggregate, 22.81, from the first 20.03 giving –2.78. S.90(3)(b) brings this figure (a debit because negative) into account at the beginning of period 4. The net taxable income for period 4 becomes 13.00 (mark to market method) less 2.78 = 10.22.

The provision is effective. The total cumulative taxable amount by the end of year 4 equals that with mark to market from commencement.

Year	**Taxable for year**	**Method**
1	7.43	Accruals
2	8.54	Accruals
3	9.81	Accruals
4	10.22	Mark to market less relief above
Cumulative amount	**36.00**	

Change from mark to market method (years 1-3) to accruals method at start of year 4

S.90(5) addresses such a change.

Again, under S.90(3)(a)(i) make the assumption in S.90(4). Then compute the credit for year 3 which is 13.00 (mark to market) and for year 4 which is 14.05 (applying S.90(5) closing actuarial value 87.05 less deemed acquisition at 73.00) 13.00 + 14.05 = 27.05.

Under S.90(3)(a)(ii) aggregate the credits for year 3 of 13.00 (mark to market) and year 4 of 11.27 (accruals method) to give 24.27. These are computed without the S.90(4) disposal assumption.

To complete the calculations, under S.90(3)(a)(iii) deduct the second aggregate of 24.27 from the first aggregate of 27.05 to give 2.78, a credit since positive. This credit is added to the year 4 taxable income which becomes 11.27 + 2.78 = 14.05.

The overall result equals that if accruals had been applied since acquisition. No debits or credits escape taxation.

Year	Taxable for year	Method
1	(5.00)	Mark to market
2	15.00	Mark to market
3	13.00	Mark to market
4	14.05	Accruals plus additional credit computed above
Cumulative amount	**42.05**	

7.4.5. Accounting for stripping or reconstituting a gilt

The legislation prescribes the calculations when a gilt is stripped or reconstituted.

7.4.5.1. Company using mark to market accounting

No special difficulties should arise. E.g. at the period start the company owns a gilt. During the period, it breaks the gilt down into strips and may sell some, retaining the others. Its taxable income should be:

Value at period end of gilt strips retained.	+
Proceeds from gilt strips sold during the period	+
Less value at start of period of gilt then owned	-
Taxable income for the accounting period	Sum

Despite this simplicity, the legislation considers it necessary to address the matter explicitly. A new section ICTA 1988 S.730C is introduced by FA 1996 S.202(8) and Sch.40 para.7. Stripping or reconstituting a gilt causes a deemed disposal and reacquisition at market value, along the lines discussed below for accruals accounting.

In the writer's view, ICTA 1988 S.730C may be otiose as it should produce the same result as above.

7.4.5.2. Company using accruals accounting

Stripping is more problematical with accruals accounting. This is addressed by S.95(2), which deems the gilt to be disposed of at its market value, and the strips acquired at an aggregate cost equal to that market value. That aggregate is then allocated over the strips pro-rata to their individual market values.

Assume that:

- on 1 January 1998 the investor purchased £100 nominal of the gilt on page 28 for £78.33.
- the investor receives £3.50 interest on 30 June 1998.
- on 30 September 1998 it strips the gilt, and sells all of the strips except the £103.50 due 31 December 2007.
- by 30 September 1998 the yield curve has changed and the market value of the gilt on that date is £80.00.
- the market values of the individual strips aggregate to £85.66 as against the value of the unstripped gilt of £80.00.

Such a large difference (£85.66 vs. £80.00) would be arbitraged away very quickly. However a small difference in value between the aggregate of the strip values and the whole gilt is feasible (see discussion of the rationale for stripping on page 34) and the legislation clearly allows for it. The large difference used makes the example easier to follow.

Payment due date	Cash payment due for this strip	Market Value of strips on 30 September 1998	Allocate market value of whole gilt before stripping	Sale proceeds of strips
31-Dec-98	3.5	3.45	3.22	3.45
30-Jun-99	3.5	3.34	3.12	3.34
31-Dec-99	3.5	3.22	3.01	3.22
30-Jun-00	3.5	3.09	2.89	3.09
31-Dec-00	3.5	2.96	2.76	2.96
30-Jun-01	3.5	2.83	2.64	2.83
31-Dec-01	3.5	2.70	2.52	2.70
30-Jun-02	3.5	2.57	2.40	2.57
31-Dec-02	3.5	2.45	2.29	2.45
30-Jun-03	3.5	2.32	2.17	2.32
31-Dec-03	3.5	2.21	2.06	2.21
30-Jun-04	3.5	2.09	1.95	2.09
31-Dec-04	3.5	1.99	1.86	1.99
30-Jun-05	3.5	1.88	1.76	1.88
31-Dec-05	3.5	1.78	1.66	1.78
30-Jun-06	3.5	1.68	1.57	1.68
31-Dec-06	3.5	1.59	1.48	1.59
30-Jun-07	3.5	1.50	1.40	1.50
	Subtotal	43.65	40.76	43.65
31-Dec-07	103.5	42.01	39.24	
		85.66	**80.00**	**43.65**

The gilt strip retained will mature at £103.5 on 31 December 2007 and has an initial accounting value of £39.24 on 30 September 1998. Accruals calculations will uplift this to £40.28 at 31 December 1998.

The company's taxable income for 1998 will be:

Interest received 30 June 1998		**£3.50**
Deemed disposal proceeds of gilt on 30 September	£80.00	
Original cost of gilt on 1 January	£78.33	**£1.67**
Proceeds of gilt strips sold	£43.65	
Deemed cost of strips sold	£40.76	**£2.89**
Accrued accounting value of retained strip 31 December	£40.28	
Deemed cost of retained strip	£39.24	**£1.04**
Total taxable income for 1998		**£9.10**

S.95(3) contains mirror provisions for reassembling a collection of individual strips into a gilt. All of the gilt strips are deemed disposed of at their individual market values, and that aggregate amount is deemed given as consideration for the reconstituted gilt.

7.4.6. Stripping other bonds

S.95 only applies to gilts. FA 1996 fails to address UK investors stripping other things such as US government bonds.

While S.95 provides persuasive guidance, the writer considers alternative accruals basis calculations possible. Merely converting a bond into strips, which is fully reversible, should not be a disposal, absent a statutory rule such as S.95. Accordingly, for a non-gilt, the stripping calculations could be prepared as follows:

Payment due date	Cash payment due for this strip	Market Value of strips on 30 September 1998	Allocate cost of whole gilt	Sale proceeds of strips
31-Dec-98	3.5	3.45	3.15	3.45
30-Jun-99	3.5	3.34	3.05	3.34
31-Dec-99	3.5	3.22	2.94	3.22
30-Jun-00	3.5	3.09	2.83	3.09
31-Dec-00	3.5	2.96	2.71	2.96
30-Jun-01	3.5	2.83	2.59	2.83
31-Dec-01	3.5	2.70	2.47	2.70
30-Jun-02	3.5	2.57	2.35	2.57
31-Dec-02	3.5	2.45	2.24	2.45
30-Jun-03	3.5	2.32	2.12	2.32
31-Dec-03	3.5	2.21	2.02	2.21
30-Jun-04	3.5	2.09	1.91	2.09
31-Dec-04	3.5	1.99	1.82	1.99
30-Jun-05	3.5	1.88	1.72	1.88
31-Dec-05	3.5	1.78	1.63	1.78
30-Jun-06	3.5	1.68	1.54	1.68
31-Dec-06	3.5	1.59	1.45	1.59
30-Jun-07	3.5	1.50	1.37	1.50
	Subtotal	43.65	39.91	43.65
31-Dec-07	103.5	42.01	38.42	
		85.66	**78.33**	**43.65**

The gilt strip retained will mature at £103.5 on 31 December 2007 and has an initial accounting value of £38.42 on 30 September 1998. Accruals calculations will uplift this to £39.47 at 31 December 1998.

The company's taxable income for 1998 would be:

Interest received 30 June 1998		**£3.50**
Deemed disposal proceeds of gilt on 30 September	N/A	
Original cost of gilt on 1 January	N/A	
Proceeds of gilt strips sold	£43.65	
Deemed cost of strips sold	£39.91	**£3.74**
Accrued accounting value of retained strip 31 December	£39.47	
Deemed cost of retained strip	£38.42	**£1.05**
Total taxable income for 1998		**£8.29**

IRLRM[4] at CT12746 mentions stripping non-gilts, but says only that S.80(5) precludes a charge under ICTA 1988 S.730.

7.5. Charging tax on credits

Under S.80(5) the loan relationships charging provisions are exclusive for corporation tax purposes "*subject to any express provision to the contrary*".

7.5.1. Distributions

Under Sch.9 para.1 credits and debits exclude distributions.

7.5.2. Trading credits

Under S.82(2)(a) if the company has a loan relationship for the purposes of a trade that it carries on, the credits are treated as trade receipts.

7.5.3. Non-trading credits

Otherwise under S.80(3) credits in respect of a loan relationship are taxable under schedule D case III.

7.6. Meaning of loan relationships for trading purposes

Under S. 82(2) one needs to determine if "*a loan relationship of a company is one to which it is a party for the purposes of a trade carried on by it*". If so, the debits and credits arising are dealt with as in sections 7.7.1 and 7.5.2 above.

There is no elaboration of this general definition. S.103(2) clarifies the position only for creditor relationships. The use of "integral" is clearly intended to narrow the definition. E.g. under old law taxpayers (seeking to offset brought forward losses) often contended that interest earned on surplus cash arising from, say, customer deposits, was a trading receipt. Such contentions will be much more difficult in future.

In Parliament on 29 February 1996 the Government indicated that the allocations between trading / non-trading in the company's accounts would be followed. However, accounts often do not contain an explicit allocation.

In the writers personal view:

- If a trading company has no non-trade assets (such as shares in subsidiaries or loan assets) then all of its borrowings must be for the purposes of its trade. Liabilities finance assets, and if there are no non-trade assets, that concludes the position.

- Where a company has both trading assets and non trade assets, the most intellectually consistent approach would be to allocate the interest debits between the trading assets and the non-trading assets pro rata to their costs. This approach recognises that money is fungible.

The writer's approach is not shared by Parliament, the Courts or the Inland Revenue. S. 82(2) clearly envisages a purposive analysis.

The Privy Council considered the allocation of interest under Mauritius law in Consolidated Investment and Enterprises Ltd v Commissioner of Income Tax, and held that the interest expense should be allocated pro-rata to the categories of income involved. The writer does not regard this case as assisting with the purposive analysis required by S.82(2).

7.7. Giving relief for debits

7.7.1. Trading debits

Under S.82(2)(b) if a company has loan relationships for the purposes of its trade, then any debits are treated as expenses of that trade.

S.82(7) overrides the rules regarding allowable deductions in ICTA 1988 S.74. Accordingly, complications such as annual interest incurred for the purchase of capital assets being a "charge" are gone.

7.7.2. Non-trading debits

In all other cases, the debits are referred to as "non-trading debits" and under S.82(3) must be subtracted from any non-trading credits.

The subtraction produces:

1. A positive number. This net non-trade credit is taxable under schedule D case III.

2. Zero. There is nothing to tax or relieve.

3. A negative amount. This net non-trade debit is called a "*non-trading deficit*" in the legislation. See 7.7.3

7.7.3. Utilisation of non trading deficit (i.e. net non-trading debits)

S.83(2) sets out the available claims for a non-trade deficit. Four specific claims are possible for the whole or any part of the non-trade deficit. A fifth "default" option applies in the absence of a claim.

7.7.3.1. Set off against any other current period profits

Sch.8 para.1(3) stipulates that the non-trade deficit is relieved:

- After brought forward trade losses

- Before current year trade losses offset under ICTA 1988 S.393A(1)

- Before subsequent period trade losses carried back under ICTA 1988 S.393A(1)

- Before subsequent period non-trade deficits carried back under S.83(2)(c)

TCGA 1992 S.8(1)(b) deducts brought forward allowable losses from current period chargeable gains before including chargeable gains in profits. Accordingly, non-trade deficits are relieved after brought forward allowable losses.

With ICTA 1988 S.393A(1) now giving terminal loss relief, current year non-trade deficits are relieved before it.

7.7.3.2. Surrender the deficit as group relief.

Under Sch.8 para.2(2) the surrender is treated for group relief purposes as if it were a trade loss.

The denial of group relief under ICTA 1988 S.397 (losses from farming and market gardening) and S.393A(3) (losses of Case V trades and trades not conducted on a commercial basis with a view to gain) is not applicable.

Old law permitted surrender of "charges on income" only after offset against the company's profits. The new rules eliminate the double tax relief problem of interest expense in a company holding foreign shares. See 7.15

7.7.3.3. Carry back against profits of earlier accounting periods.

Under Sch.8 para.3(4) a non-trade deficit carried back can only be offset against schedule D case III profits on loan relationships (i.e. non-trade credits.) The relief is given after:

- brought forward losses or deficits
- trade charges (e.g. royalties)
- investment company capital allowances, management expenses and "business charges"
- trade losses of current or future periods
- earlier period non-trade deficits offset against other income
- group relief for other companies non-trade deficits

The priority list in Sch.8 para.6 is silent about group relief claimed for other companies' trading losses, as opposed to group relief claimed for other companies' non-trade deficits. However ICTA 1988 S.407(1)(a) makes it clear that group relief always takes priority to a carried back non-trade deficit.

F(No. 2)A 1997 S.40 shortened the carryback period from three years to 12 months.

7.7.3.4. Carry forward against non-trading profits of next accounting period.

Sch.8 para.4(3) directs one to ICTA 1988 S.393A to determine what constitutes "non-trading profits." S.393A(9)(b) looks at the actual trade carried on by the company to determine what falls outside it.

7.7.3.5. Default option

If the company makes none of the claims above, under S.83(3) the non-trade deficit is carried forward as a "non-trading debit" into the immediately following period.

S.83(4) prevents such a brought forward non-trading debit being used to make larger any claim under S.83(2)(a)–(c) in a future period.

Sometimes the default option of S.83(3) is preferable to claims under S.83(2). e.g. a single company has:

Trading profit or loss	Non-trade debits	Chargeable gains

	Trading profit or loss	Non-trade debits	Chargeable gains
Year 1	10		
Year 2	(30)	(20)	20
Year 3	(30)		20
Year 4	10		20
	(40)	(20)	60

If the company under S.83(2)(a) offsets the year 2 non-trade deficit against chargeable gains, under Sch.8 para.1(3)(b)(i) it takes priority to the trading loss, which carries forward. In year 4 the company will be taxed on chargeable gains of 20 despite (20) surplus trading losses.

Similarly electing under S.83(2)(d) to offset the year 2 deficit against the year 3 chargeable gains is undesirable.

Optimally, the company should make no year 2 election for its non-trade deficit, which then enters year 3 as a brought forward non-trade debit. In the year 3, the company elects under S.83(2)(d) to offset the deficit against year 4 chargeable gains.

7.7.3.5.1.Subsequent legislative clarification

FA 1998 S.82 is deemed to have always had effect. It revises FA 1996 S.83(3) & (4) and ICTA 1988 S.797 and 797A to ensure that any amount brought forward under S.83(3)

- can be likewise carried forward so that the company is not required to offset it, e.g. against income with DTR
- can be disregarded as a debit for the DTR limitations discussed in section 7.15.

7.7.4. “Hybrid” companies.

A hybrid company was a trading company that also carried investing activities, without qualifying as an investment company. Interest on loans to purchase investments was a non-trade charge.

There were no statutory provisions under which excess non-trade interest could be carried forward; it was simply lost. FA 1996 eliminates this problem with clear carry forward provisions for non-trade debits.

7.7.5. Pre-trading expenditure

Pre-trading loan relationship debits can be relieved as non-trade debits if desired, including group relief discussed in 7.7.3.2.

However pre-trading consortium companies cannot make a surrender as Sch.8 para.2(2)(a) does not deem the company to be trading for the purposes of ICTA 1988 S.402(3)(a).

7.7.5.1. Carry forward election

Sch.14 para.20(1) also permits election for such items to be carried forward and treated as trading debits deductible as expenses on the commencement of trade.

7.7.5.2. Other pre-trade charges

Sch.14 para.20(2) therefore repeals ICTA 1988 S.401(1A). A possibly unintended consequence is to eliminate relief for pre-trade charges other than interest, such as patent royalties.

7.8. Grandfathered gilts

Governments have long promoted low coupon gilts to higher rate taxpayers. Issued a discount, the investor realised a tax-free gain on redemption. The pricing of the gilts reflected their terms and attractiveness to higher rate taxpayers.

There were complaints regarding retrospection when the May 1995 "Gilts and Bonds" proposals were intended to apply to individuals as well as companies. In response, the authorities announced that those low coupon gilts mostly held by private investors would be "grandfathered."

Apart from a few instances discussed in section 7.19 individuals are now outside the new rules. However, S.96 “grandfathers” (for corporation tax) the gilts involved, being 3 1/2 % Funding Stock 1999-2004 and 5 1/2% Treasury Stock 2008-2012. The only charge under the loan relationship rules is on interest. Authorised accruals accounting must be used.

7.9. Manufactured interest

This is covered in S.97.

“Manufactured interest” sounds arcane. It arises in two basic circumstances, illustrated below using £100 face value of the hypothetical gilt from page 28.

7.9.1. Stock lending

Suppose a dealer has sold a gilt to a purchaser (e.g. £100 Hypothetical Treasury Stock 2007 sold on 15 June 1998 for say £78.00 including 5.5 months accrued interest) without the dealer owning the gilt. The dealer must deliver the gilt to the purchaser on completion, assumed to be almost immediately. He can:

1. Purchase the gilt for around £78.00.

2. Borrow the gilt from someone. The dealer would borrow if he expected a price fall.

Assume the dealer borrows £100 face value of the gilt from a long-term investor on 15 June 1998 for return on 15 July 1998. The dealer will deliver the gilt borrowed to the purchaser. By 15 July 1998 the dealer will purchase the gilt in the marketplace for return to the lender.

The lender will be paid a fee for loan (e.g. 50 p for a month’s loan) and will retain the benefits of ownership. The lender will want to receive £3.50 gilt interest on 30 June 1998.

The third party purchaser will receive the real gilt interest gilt. On 30 June 1998 the dealer pays £3.50 from his own resources to the lender to compensate the investor for not receiving the real interest payment. This £3.50 payment is "manufactured interest."

S.97(1)-(3) treats the manufactured interest payment like actual interest. The recipient is taxed as if it were interest received under the actual loan relationship (in this case the gilt) lent. For the payer, the manufactured interest gives a trading or non-trading debit as appropriate. For the dealer discussed above, the payment would be a trading debit.

Commercially the lender has credit risk. If the dealer becomes insolvent, the gilt will not be returned. If the dealer is highly credit worthy, the investor may accept this credit risk. Alternatively, he may require the dealer to provide a bank guarantee or security over a cash deposit.

Unlike the repo discussed below, the investor is not borrowing any money by lending the gilt. He is merely earning the loan fee while enjoying all the benefits of ownership.

7.9.2. Repo

Under a repo contract the owner of securities agrees to sell them and agrees to repurchase them at a specified price on a specified future date. It is equivalent to borrowing money using the securities as collateral. However, a repo contract is much simpler to implement than a loan agreement. The money provider under a repo (i.e. the purchaser) is much more secure if the original owner becomes insolvent.

Repos have long been commonplace in continental and United States government debt markets. However, the UK government bond market did not facilitate repo until 1995. The law was then changed to increase the attractiveness of UK government securities. There were previous arrangements for "stock lending" but limited to approved gilt edged market makers.

7.9.2.1. Repo illustration

Consider the holder on 30 September 1998 of a zero coupon government bond due on 31 December 2007. From page 53, a bond with a face value of £103.50 would have a market value of £42.01. The investor wishes to borrow for three months, and finds a counterparty.

- On 30 September 1998 the investor sells the bond to the counterparty for, say, £40.00. Under the same contract, the investor agrees to repurchase the bond on 31 December 1998 at, say, £40.50.

- On 30 September 1998 the investor receives £40.00 cash and delivers the bond.

- On 31 December 1998 the investor pays £40.50 cash and re-acquires the bond.

The selling price on 30 September 1998 will be fixed just below market value. The goal is equitable distribution of the credit risks:

- Using market value exposes the counterparty to risk. By 31 December the bond value might have fallen, while the investor defaults on his repurchase commitment.

- An excessively low price exposes the investor to risk if the counterparty becomes insolvent and cannot return the bond on 31 December 1998.

In practice, a repo contract will also contain provisions for depositing margin if the market value of the underlying bond fluctuates outside set boundaries.

While the selling price is based on the market value at 30 September 1998, the repurchase price is not linked to the expected value of the security on 31 December. Instead, it is simply the original sale price plus interest at short term rates for the three months.

7.9.2.2. Tax rules for repo

Under ICTA 1988 S.730A(2)(a) the excess of repurchase price over sale price is treated as interest on a deemed loan (equal to the original sale price) from the interim holder. Tax law follows the transaction economics.

Old law treated the repo "interest" as yearly interest. FA 1996 Sch.14 para.37 amends ICTA 1988 S.730A(6) treating the deemed interest as arising under a loan relationship and introduces a new S.730A(6A) regarding the trading / non-trading classification.

ICTA 1988 S.737A is an anti-avoidance provision applying where a repo straddles an interest payment date and the contract terms allow the interim holder to keep the interest receipt while reflecting its value in the specified repurchase price. S.737A(5) deems the interim holder to pay manufactured interest to the transferor. This deemed payment can then be made subject to tax or to withholding tax as appropriate. S.97(4) ensures integration with the loan relationship rules.

Absent ICTA 1988 S.737A, repo could allow, for example, avoidance of withholding tax on corporate bond interest.

Sch.9 para.15 prevents the legal sale and repurchase transactions constituting a repo being "related transactions" under S.84. Instead they are disregarded.

Sch.9 para.15(3)(b) is important anti avoidance legislation. Repo treatment applies if a person connected (within ICTA 1988 S.839) with the transferor is the repurchaser or if the rights re-acquired are "equivalent" to the rights sold, i.e. the reacquisition need not be of the same asset.

Without this, accruals accounting group companies could use sales (with repurchase by other group companies) to selectively crystallise tax relief on falls in their loan relationships' market values.

FA 1997 S.76 & 77 extended these rules to apply, mutatis mutandis, to stock lending and repo transactions in other investments such as equities.

7.10. Preserving the tax charge on other interest income

Interest can arise on money debts that are not loan relationships, such as the examples in 7.3.1.2.

S.100(2) preserves a tax charge by deeming interest to be payable under a loan relationship. The charge is only on interest, not on other debits or credits.

S.100(3) enables interest income to be deemed to arise and be taxed in respect of transfer pricing adjustments under ICTA 1988 S.770. Similarly Sch.9 para.16 ensures an effective tax charge on deemed interest arising on an actual loan relationship due to the application of the transfer pricing rules.

7.11. Amounts taken to reserves

S.84(2)(b) explicitly includes in the charging provisions any profits, gains or losses which are carried to any reserve maintained by the company, other than its share premium account.

S.84(2)(a) excludes any debits or credits which are "*required to be transferred to the company's share premium account.*" The key word here is "*required*".

Under CA 1985 S.130(1) where shares are issued at a premium, "*the premiums on those shares* <u>*shall*</u> *be transferred to an account called 'the share premium account.'*" Such credits would be

outside the new rules anyway, as shares are not loan relationships. Critically, CA 1985 S.130(2) is only permissive: "*The share premium account* *may* *be applied … in writing off … the expenses of, or the commission paid or discount allowed, on any issue of … debentures … or in providing for the premium payable on redemption of debentures.*"

Accordingly, the writer considers such costs continue to be deductible even if charged to the share premium account. The Inland Revenue have confirmed in correspondence that they concur.[6]

7.12. Expenses

S.84(1)(b) allows recognition of all charges and expenses incurred under or for the purposes of a company's loan relationships and related transactions. However proper accruals accounting after FRS4[7] requires issue costs to be amortised over the life of the loan, so a deduction on payment is no longer permissible.

Old law in ICTA 1988 S.77 gave relief for the costs of obtaining a loan but did not give any relief for a penalty on early repayment of an onerous loan.

S.84(4) ensures relief for abortive expenses.

7.13. Capitalised interest

Interest charged to capital has long been a cause of difficulty in the tax system. e.g. Chancery Lane Safe Deposit & Offices Co Ltd v IR Commissioners, 43 TC 83.

Sch.9 para.14 requires capitalised debits and credits to be recognised in the accounting period they relate to, ignoring their capitalisation.

Sch.9 para.14 applies only to debits (and credits) which are used to determine "*the value of a fixed capital asset or project*". In the writer's opinion, this is to be read as "*fixed capital asset or* [fixed] *project*".

Interest debits capitalised into balance sheet current assets (e.g. work in progress) are not deductible in the period that they relate to. Instead, the debit remains within the trading stock cost, and only becomes an expense when the stock is sold.

7.14. Withholding of income tax from interest payments

Only limited changes have been made to the withholding rules.

7.14.1. Government Securities

Interest on gilts is paid gross from 6 April 1998 under F(No 2)A 1997 S.37. The gilt strips market would not function if income tax were withheld from the entire payment when a stripped interest coupon became due.

7.14.2. Interest payments by companies

There have been no fundamental changes to the rules.

Apart from specific exemptions such as quoted Eurobonds (ICTA 1988 S.124) one still needs to consider the traditional distinction between "short interest" (no deduction of tax at source) and

"annual interest" which requires it. A detailed discussion of this distinction is outside the scope of this thesis.

7.14.3.Relief for income tax withheld

Under ICTA 1988 S.7(2) income tax withheld is relieved against corporation tax for the accounting period in which the interest is taken into account. S.7(6) requires a claim in the company's corporation tax return or in an amended return.

Before FA1996 the chargeable period rarely preceded the period of receipt. Interest suffering withholding was likely to be chargeable on a receipts basis.

Now interest income is more likely to be recognised for corporation tax purposes before receipt. If the interest has not been received (and tax withheld) when the corporation tax return for the chargeable period is finalised, the company has no offset against corporation tax since nothing has actually been withheld.

S.91(2) provides a form of relief in such cases. Where an interest payment is received which has been included in the taxable income of an accounting period which ended more than two years prior to the date of receipt, then ICTA 1988 S.7(2) has "*effect in relation to the income tax on the payment as if the interest had fallen to be taken into account for the purposes of corporation tax in the accounting period in which the payment of that interest is received.*"

In the writer's opinion the effect of a claim under S.91(2) is that the income tax withheld from the interest receipt can be offset against the company's general corporation tax liability in respect of the accounting period in which the interest is received. No adjustment is made to the corporation tax liability of the original accounting period in which the interest was brought into account.

This differs from the CIOT[5] commentary and from Tolley's[8] 4.32 & 4.33. Both commentaries assume that the interest credit is eliminated from the earlier year and instead taxed in the year of receipt. The writer regards this as inconsistent with the plain words of S.91(2). IRLRM[4] at CT12706 concurs with the writer as does another commentary.[9]

7.14.3.1.Opportunity for tax avoidance

This is best illustrated by an example.

Two UK group companies each have a calendar year end. One lends the other £1,000 with 6% annual interest payable 11 months after the year of accrual. 20% deduction of tax applies. (No ICTA 1988 S.247 election is made.) The creditor files its 1997 corporation tax return in December 1998, after receiving the 1997 interest in November 1998. Each company has other income of £1000.

The cash flows are:

	Debtor	Creditor
Other income	1,000.00	1,000.00
Interest (expense) / income	(60.00)	60.00
Taxable income	940	1060
Corporation tax due 30.9.98	291.40	328.60
Offset income tax withheld		(12.00)
	291.40	316.60
Quarterly tax accounting 14.1.99		
Income tax withheld	12.00	

The group obtains relief on 30 September 1998 for income tax paid to the Inland Revenue on 14 January 1999, a 3.5 month interest free loan from the Exchequer.

With quarterly tax payments under CTSA, the benefit grows.

7.15. Double Taxation Relief (DTR)

Sch.14 para.43 gives new rules for DTR on non-trading credits, which are fair to the taxpayer. Under the newly inserted ICTA 1988 S. 797A:

- non-trade credits with associated foreign tax with them are taken into account without deducting non-trade debits. This maximises DTR.
- the non-trade debits are diminished by any amounts surrendered as group relief, or carried backwards or forwards. Accordingly, interest expense can be group relieved to preserve DTR.
- the remaining non-trade debits are allocated as the company wishes, enabling offset last against sources with foreign tax.

Overall this minimises wastage of DTR.

Sch.14 para.44 recasts the rules limiting DTR when financial traders receive interest on overseas loans net of foreign tax. The DTR was further limited by FA 1998 S.103-107.

Sch.14 para.46 introduces a new ICTA 1988 S.807A. The effect is to ensure that a company that is taxed on accruing interest receives double taxation relief even if the interest receipt and related withholding tax are received by a new owner post sale.

FA 1997 S.91 subsequently amended ICTA 1988 S.807A(3)(b) to ensure that the owner was not prejudiced by a rep of the foreign security. (Strictly, that part of the credit accruing during the repo period would not have arisen under the owner's legal ownership.)

7.16. Overseas sovereign debt

ICTA 1988 S.88A – S.88C were enacted by FA 1990 (rather late) to limit the tax relief to UK lenders from the 1980's third world debt crisis.

FA1996 recasts the old law replacing ICTA 1988 S.88A – S.88C by Sch.9 para.8 & 9. It changes the language to "*loan relationships*" and "*debits and credits*" but the writer discerns no changes of substance.

7.17. Anti-avoidance

Understandably, there are many anti-avoidance measures.

7.17.1. Interest deductions without a cash payment

Since FA 1984 Sch.9 para.5 tax law has been concerned about companies receiving tax deductions for interest to affiliates accrued but not paid.

7.17.1.1. Interest paid late

Sch.9 para.2 applies when S.87 mandates accruals accounting. If interest expense is unpaid 12 months after the accounting period end, then a deduction is postponed until the interest is paid.

In UK to UK situations, Sch.9 para.2(2)(b) protects the accruals basis deduction provided the creditor brings the full amount of the interest into account "*for any accounting period.*" This protection requires the creditor to be a company, since only they have accounting periods.

7.17.1.2. Discounted securities held by connected companies

Sch.9 para.17(1) applies if a connected company holds relevant discounted securities at any time during an issuer's accounting period. Under para.17(2) a deduction for that period's interest debit postponed until redemption.

Para.17(1)(d) protects UK to UK situations provided the creditor recognises the full amount of the period's discount.

Para.17(4) uses the Sch.13 definition of relevant discounted securities discussed on page 76. However, para.17(5) contains a freestanding definition of "connected" rather than cross-referring to S.87. The table below compares the definitions.

Connected test in S.87	Connected test in Sch.9 para.17
87(3)(a)	Matched by 17(5)(a)
87(3)(b)	Matched by 17(5)(b)
87(3)(c)	Not relevant. Para.18 applies instead.
87(4)	Matched by 17(6)
87(6)	Matched by 17(9)
87(8)	Nothing equivalent. See comment below.

The omission from para.17 of any equivalent to S.87(8) considerably widens the test. A substantial security investor can easily emerge with control due to ICTA 1988 S.417(1)(b) and S.416(2)(c) unless the banking exclusion of S.417(9) applies.

Para.17(7) demonstrates the generally good drafting of FA1996. When satisfied, it preserves the issuer's accruals basis deduction. It is needed for the same reasons as S.88 discussed in section 7.18.2

7.17.1.3.Discounted securities of close companies

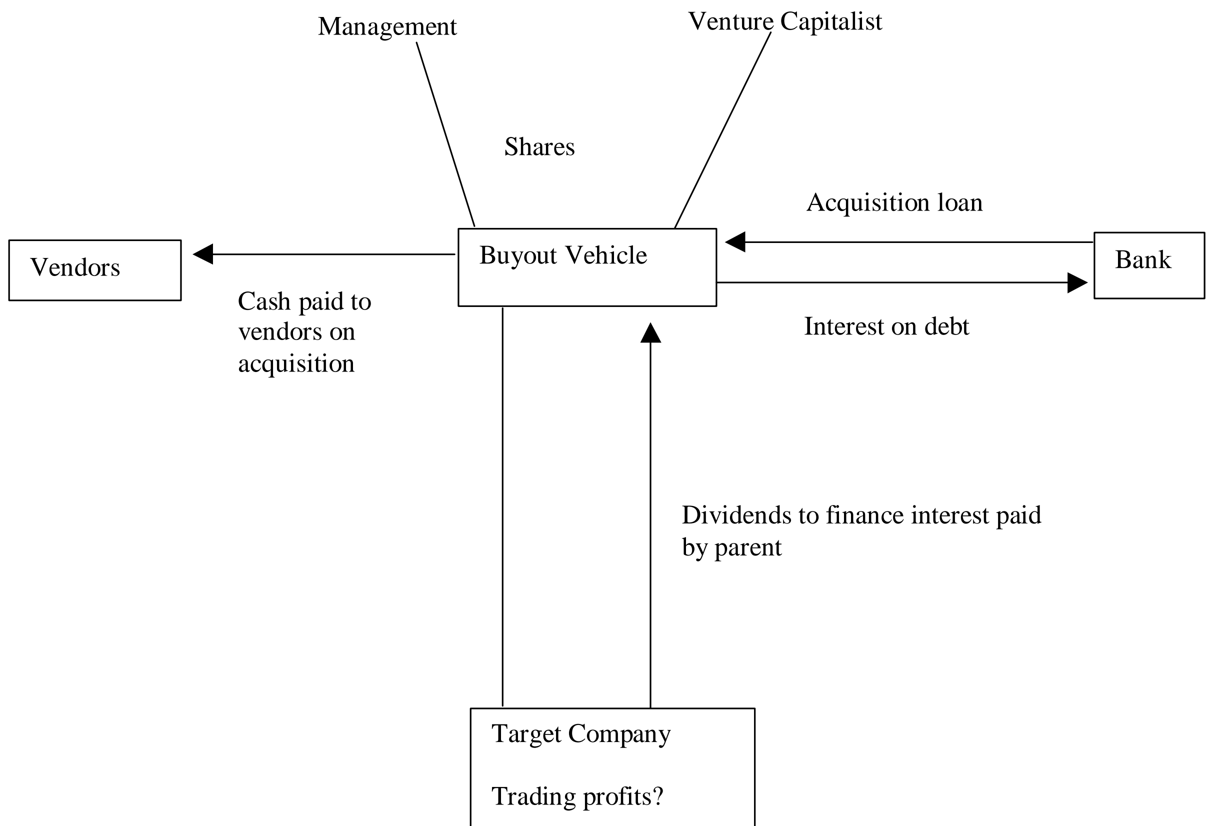
Sch.9 para.18 is a draconian provision applying if at any time in or before an accounting period the security is held by a participator, an associate of such a participator, or a company controlled by such a participator. Under para.18(2) no amount is deductible in respect of any of the discount until redemption.

The absence of any limit to the "look back" period (unlike S.87 or Sch.9 para.17) and the structure of para.18(2) covering the whole of the discount (unlike para.17(2) "*amount of the discount that is referable to the relevant period*") mean that ownership at any time by a participator disqualifies all future accruals basis deductions. This applies even if for the remainder of its existence the security is owned by an unconnected third party. It is hard to identify a rationale for this approach.

Para.18(4) and 18(5) contain some useful relaxations.

The provision applies even if the holder is a UK company taxing the corresponding credits as they accrue.

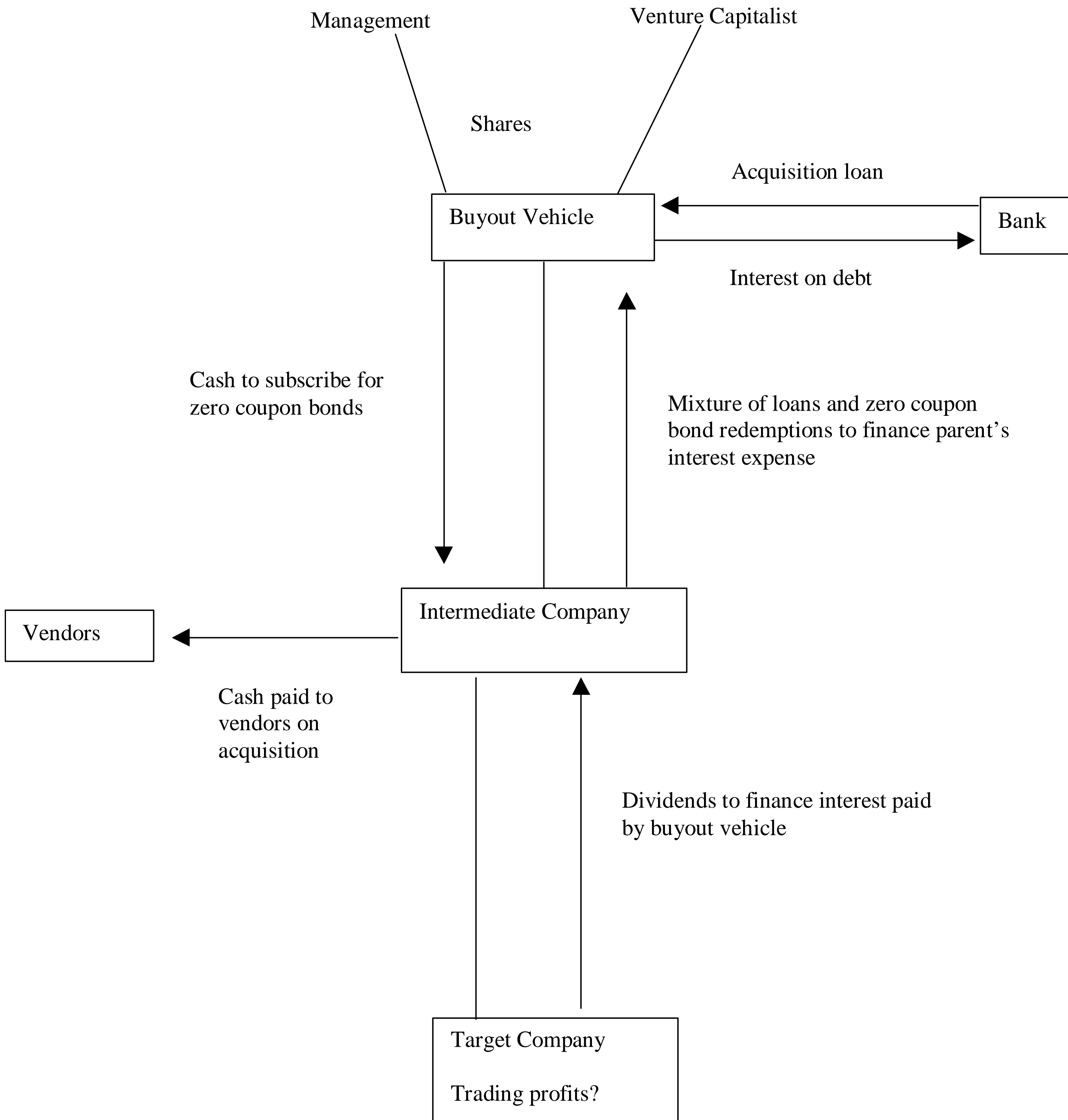
Paradoxically, Sch.9 para.18 is useful to tax planners. Consider a highly leveraged management buyout.



The buyout vehicle typically has interest expense, no taxable income, and needs to group relieve its interest expense down to the trading company. However, the trading profits maybe depressed e.g.

by restructuring costs. Excess interest expense commonly arises. Carried forward interest debits in the buyout vehicle are of limited value.

One solution involves making the buyout vehicle a close company, and cascading the finance down through an intermediate company.



This structure accelerates taxable income. The buyout vehicle accrues taxable income on its holding of zero coupon bonds. This taxable income shelters its interest expense paid to the bank, protecting against excess deductions.

Typically, the zero coupon bonds will exceed the buyout vehicle's acquisition debt. The buyout vehicle will have issued share capital as well as debt, and the total purchase money raised can be cascaded down to the intermediate company as zero coupon bonds.

Under Sch.9 para.18 the intermediate company has no accruals basis deduction. The group should have an overall taxable profit before zero coupon bond redemptions.

The group's overall tax position can then be "fine tuned" to break even by redeeming just enough zero coupon bonds each year to generate tax deductions for the intermediate company.

7.17.2. Continuity of treatment in groups of companies

Sch.9 para.12 is the loan relationships equivalent of TCGA 1992 S.171. Very briefly, transfers of a loan relationship between group companies are ignored, except to ascertain which company is taxed/relieved on the debts/credits.

Para.12(8) applies para.11(5) to use the capital gains tax definition of a group.

Continuity applies when a “related transaction” (s.84 definition) either directly between group companies or indirectly via a series of transactions (which can involve third parties) results in one group company replacing another as party to a loan relationship.

The transfer transaction gives rise to no debits/credits. The transferor and transferee are deemed to be the same company, except when deciding who recognises debits and credits arising from the underlying loan relationship.

Para.12(6) stops continuity being avoided by a new loan relationship with equivalent provisions.

To illustrate the need for the continuity rule, assume:

- UK Parent has lent £100 to UK subsidiary A for 10 years at 10% interest.
- Later, UK interest rates fall well below 10%. Subsidiary A’s liability has become onerous, with a fair value of say £150. Subsidiary A wants tax relief on £50 without Parent being taxable.

Suppose subsidiary A pays fellow subsidiary B £150 to take over subsidiary A’s onerous loan. Subsidiary A deducts the £50 related transaction payment in the period it is paid. Subsidiary B would bank the cash received and account for a £150 liability on its balance sheet. Annually subsidiary B will pay £10 interest to Parent, and also write the £150 liability down towards £100 (the amount eventually repayable) with the write down being a taxable credit.

Overall the group receives a £50 initial deduction recaptured over the remaining life of the loan. This mischief is prevented by para.12.

The anti-avoidance aspects of para.12 are flawed by the use of the capital gains tax definition of a group. If subsidiary A and subsidiary B were both held directly by an overseas parent, the scheme illustrated above would not be prevented by continuity treatment.

7.17.3. Imported losses

FA 1996 Sch.9 para.10 prevents losses being imported by companies using accruals accounting.

To illustrate the mischief, assume an overseas multinational group, so we can ignore the “controlled foreign companies” rules. On 1 January 1998 the group incorporates two new tax haven subsidiaries.

- Subsidiary A issues £10,000,000 share capital and invests in a third party zero coupon bond.

- Subsidiary B has share capital of £1 and borrows £10,000,000 by issuing a zero coupon bond to a third party, in practice with a parental guarantee. The £10,000,000 cash received is loaned to the parent company.

Market interest rates always fluctuate. By 31 December 1998 assume they have risen. Subsidiary A becomes UK resident on 1 January 1999 and joins the multinational's UK sub-group. Subsidiary B remains tax haven resident.

On 2 January 1999 subsidiary A sells its zero coupon bond investment at a loss. (Interest rates have risen so the bond has fallen in value.) Meanwhile, Subsidiary B buys in its zero coupon bond liability for less than the issue price, making a gain. Subsidiary A's loss is group relieved, while Subsidiary B's gain on debt repayment occurs overseas.

The tax avoidance opportunity only exists with accruals accounting. With mark to mark accounting, as becoming UK resident starts an accounting period, the loan relationship position would be marked to market. Consequently UK tax effect would only be given to later economic changes.

Accordingly, Sch.9 para.10 is limited to cases of accruals accounting. Under Sch.9 para.10(2) "*no part of the loss that is referable to a time when the relationship was not subject to UK taxation shall be treated…as arising in the loss period or any other accounting period of the chargeable company*".

No computational guidance is given. Sch.9 para.10(3) merely defines the relevant time period. The writer recommends determining the "fair value," defined in S.85(6), when the loan relationship enters the UK, with only subsequent losses deductible.

Sch.9 para.10(4) guards against transference of the loan relationship, e.g. with group continuity after immigration. Otherwise the transferee could argue that it was never a party to the loan relationship while that was outside the charge to UK tax.

7.17.4. Related transactions not at arms length

Loan relationships between UK companies and non-resident affiliates are within the transfer pricing rules in ICTA 1988 S.770

Sch.9 para.11 protects the Exchequer more widely from "related transactions" (see para.11(1)(b)) which are not at arms length but outside a group so escaping continuity treatment.

Consider two UK companies owned by the same individual. One owns a bond which it sells the other at an undervalue. Without Sch.9 para.11 the first company would have an immediate debit from the loss, while the second company would spread the gain from the bargain purchase over the bond's life.

7.17.5. Unallowable purposes

Sch.9 para.13 is the best known anti avoidance provision in the new rules.

7.17.5.1. Basic outline of the rules

Para.13(1) can be summarised:

- identify "*in any accounting period*" if a loan relationship has *an "unallowable purpose*"

- if yes, compute the debits (using an authorised accounting method in the normal way) and on a "*just and reasonable basis*" determine what part of the debits are "*attributable*" to the unallowable purpose.

- exclude from the debits "*brought into account*" (i.e. the tax-deductible debits) the part attributable to the unallowable purpose.

The provision is clearly purposive rather than objective. On infringement, only the tainted part of the debits is disallowed.

Under para.13(2) one seeks the purposes for which the company is a party to the loan relationship or the purposes for which the company enters into related transactions. If those purposes include a purpose "*which is not amongst the business or other commercial purposes of the company*" then the loan has an unallowable purpose.

Two guides are given.

Para.13(3)

The business or other commercial purposes of the company do not include "*the purposes of any part of its activities in respect of which it is not within the charge to corporation tax*". This would deny relief for interest on borrowings for mutual trading such as a bar in an incorporated working men's club.

Para.13(4)

This is helpful to the taxpayer. Paraphrased, a tax avoidance purpose is a business or commercial purpose, provided it is not the main purpose, or one of the main purposes, for which the company enters into the transaction.

However, a tax avoidance purpose is not limited to tax avoidance by the company. It extends to any purpose (of the company) that consists in securing a tax advantage for any other person. The definition of "tax advantage" used is that in ICTA 1988 Part XVII Chapter I, i.e. S.703 – S.709, set out in S.709(1). Tax is defined in S.832(3) and means income tax or corporation tax.

7.17.5.2.Application to accounting periods

Sch.9 para.13(2) looks at "*the purposes for which at times during that period, the company is a party to the relationship*". Arguably, often a company has no such purposes during that period.

Consider a company that in 1998 issues a 10-year non-callable bond, to a third party, for an admitted tax avoidance purpose. In making its plans during 1998, the company fully expects tax advantages to arise throughout the 10-year bond life.

Throughout 1999, the company is a party to the loan relationship. However, that is because it was already a party to the bond at the start of 1999, and is contractually committed. It could only escape the bond by a breach of contract, which would be litigable. Further, such conduct would damage the company's general commercial reputation.

Can the Inland Revenue argue that the company has a tax avoidance purpose during 1999? They will certainly wish to, and with current judicial attitudes the Inland Revenue would almost certainly prevail.

However, in the writer's opinion the words of Sch.9 para.13 do not support such an interpretation. They require one to look at the actual purpose of the company in 1999 for being a party to the loan

relationship. In 1999 the company either has no purpose at all for being a party, or its only purpose is to preserve its general commercial reputation.

In opposite circumstances, IRLRM[4] at CT12685 (correctly in the writer's view) consider Sch.9 para.13 applicable where a company has originally entered into a loan relationship for commercial purposes, but subsequently allows the loan relationship to continue in existence to avoid tax.

7.17.5.3.Parliamentary "clarification"

The question of what qualifies within "*the business or other commercial purposes of the company*" has been the subject of much speculation.

The Economic Secretary to the Treasury commented on the provision during the FB1996 Report Stage, Hansard 28 March 1996. The comments are not worth summarising as they do little to clarify when the legislation is likely to be invoked.

7.17.5.4.Comparison with closely related tax law

FA 1996 was the third modernisation stage, following foreign exchange and financial instruments, each with its own key anti-avoidance rules.

7.17.5.4.1.Foreign exchange

Under FA 1993 S.135(1)(c) an exchange loss is disregarded if "*the nominal currency of the asset or liability is such that the main benefit or one of the main benefits that might be expected to arise from the company's holding the asset or owing the liability is the accrual of the loss*".

This is an objective test. If infringed, the whole exchange loss is disallowed.

7.17.5.4.2.Financial instruments

There are extensive anti-avoidance provisions in FA 1994 S.165 – S.168. However most target concerns that UK taxpayers will transfer value to related persons.

The closest to a motive test is FA 1994 S.167(2)(a). This applies where a financial instrument contract has been entered into, and if the parties had been dealing with each other on arms length terms the contract would not have been entered into at all (or would have been entered into on different terms).

Under FA 1994 S.167(2)(a) all the deductions arising to the offending company are reduced to nil.

This could be used to attack a tax motivated financial instruments contract. It may be possible to show that, although the contract uses market pricing, arms length third parties would not have entered into the contract at all.

E.g. after writing a large derivative contract between two UK subsidiaries, market fluctuations soon generate a loss in one and a gain in the other, offsettable by group relief. Closing out the derivative and liquidating the lossmaking subsidiary produces an allowable loss, with no group economic loss. (The other subsidiary is retained.)

FA 1994 S.167(2)(a) is effective to counter this, even with market pricing used for all transactions. If the subsidiaries had been dealing at arms length, they would not have entered into the transactions at all, having no commercial reason for them. (ICTA 1988 S.703 may also assist the Inland Revenue).

7.17.5.4.3.Conclusion

No attempt has been made to use consistent anti-avoidance language in FA 1993, 1994 and 1996. While the subject matters differ, in the writer's opinion the inconsistency is most likely due to different drafting styles. Under FA 1993 and FA 1994 the deduction is disallowed in full, whereas FA 1996 takes a more reasonable approach, ascertaining and disallowing only the part of the debit relating to the unallowable purpose.

7.17.5.4.4.ICTA 1988 S.787

This was enacted specifically in 1976 to counter the "pre-paid interest scheme" then marketed. It has been little used. This provision applies an objective test, which, if infringed, disallows all of the interest.

Logically it should have been repealed (for corporation tax purposes) post Sch.9 para.13. Presumably it was retained as a "belt and braces" deterrent against tax avoidance.

7.18. Connected persons

Many special rules apply.

7.18.1.Connectedness test of S.87(3)

Under S.87(3) a company is connected with another person for an accounting period, if at any time during that accounting period, or in the two years before the beginning of that period, the control tests of S.87(3)(a)-(c) are satisfied.

The control test used is ICTA 1988 S.416(2)-(6). Similarly, S.87(7) imports "*participator*" and "*associate*" from ICTA 1988 S.417 modified by S.87(8) so a person is not a participator "*by reason only that he is a loan creditor of the company.*"

These provisions look standard to a tax practitioner. However they give rise to at least one very difficult point which troubled the writer and a major law firm on a mortgages securitisation, where a building society granted a subordinated loan to the special purpose vehicle.

Very briefly, does the S.87(8) limitation to the participator definition "*for the purposes of this section*" apply:

1. Only narrowly to the use of participator in S,87 itself, i.e. S.87(3)(c)

2. Widely so that a loan creditor cannot be found to have control under ICTA 1988 S.416(2)(c)

Simons Direct Tax Service at B3.1935 recognises the interpretation uncertainty. The Inland Revenue's view in Tax Bulletin No. 32 is that alternative 2 applies. As this generally favours taxpayers, resolution by litigation is unlikely.

7.18.2.Accounting method where parties are connected

S.87 applies to any accounting period where the company is connected with its debtor or creditor. Under S.87(2) the only accounting method permitted to the company is authorised accruals.

The mandating applies accounting period by accounting period. Accordingly, a connection during the current period does not prevent the company changing to mark to market accounting in a future accounting period when it is not connected.

7.18.3. Limited exemption from S.87

S.88 provides limited relief from S.87 to the creditor. The debtor must still use the accruals method. S.88(5)

S.88(2) contains the eligibility tests. Under S.88, the creditor can use mark to market accounting. Indeed due to S.88(2)(b) the creditor will already be marking to market.

The obvious S.88 scenario is a company wishing to issue quoted Eurobonds, S.88(2)(d)(i), or short term commercial paper having a life of less than one year, S.88(2)(d)(ii) with the transaction handled by a connected investment bank, e.g. one in the same group.

The normal issue process involves the bank acquiring all the securities and reselling to third-party investors. The investment bank typically uses mark to market and would be inconvenienced by using authorised accruals for its short period of ownership. Provided the bank sells at least 70% to third parties within three months, it should qualify under S.88(2).

7.18.4. Bad debts

Bad debts generally present no difficulty under mark to market. At each period end the fair value reflects any default risk.

However, with accruals accounting S.85(3)(c) requires that for creditor relationships (i.e. assets) one must assume that every amount payable under the relationship will be paid in full as it falls due. The only exception is authorised bad debt arrangements.

7.18.4.1. Basic bad debt rules

Under Sch.9 para.5(1) the creditor is allowed to depart from the S.85(3)(c) assumption (that all amounts will be paid) in the case of:

- a bad debt
- a doubtful debt to the extent estimated to be bad
- if a debt is released.

The first two echo ICTA 1988 S.74(1)(j) but the last is different.

Strictly ICTA 1988 S.74(1)(j) only permits tax relief for the release of a debt if the release happens "*as part of a relevant arrangement or compromise*" as defined in ICTA 1988 S.74(2). The Inland Revenue usually ignores this, perhaps because any third party release will have been preceded by the debt being "doubtful." Accordingly, Sch.9 para.5 having dropped the "relevant arrangement" should make little practical difference to creditors.

Where a debt is released, a taxable credit generally arises to the debtor, S.85(3)(e). However, Sch.9 para.5(3) provides relief. No taxable credit need be recognised:

- where the release is part of a "*relevant arrangement or compromise*" as defined, basically a voluntary arrangement under the Insolvency Act 1986 or an arrangement under CA 1985 S.425. Debtors should therefore prefer any release to be made under a relevant arrangement, even if creditors are indifferent.

- where the loan relationship is between persons connected under S.87. Non-taxation of the debtor mirrors non-relief for the creditor (discussed below). The exemption is not dependent on the connected creditor being within the corporation tax charge.

Similarly, Sch.9 para.7 protects the debtor from a taxable credit if a government loan relationship investment is released.

7.18.4.2.Bad debts between connected persons

Sch.9 para.6(3) applies when S.87 mandates accruals accounting.

Apart from debt to equity swaps (discussed at 7.18.4.3) the creditor is denied bad debt relief.

Para.6(6) prevents avoidance by a third party sale. It effectively assumes for computational purposes that the creditor has not disposed of the loan relationship at the period end. Para.6(7) clarifies the provision to prevent the creditor being taxed on amounts (e.g. future interest receipts) that accrue after the loan relationship disposal.

The provisions contain several traps. E.g. the purchase of “distressed debt” illustrated below.

Groups often have under-performing subsidiaries supported by group loans:

Under-performing Subsidiary Ltd	
Operating assets (at market value)	£ 10,000,000
Share capital	£ 1,000,000
Accumulated losses	(3,000,000)
Shareholders funds (accumulated deficit)	£ (2,000,000)
Parent company loan	12,000,000
	£ 10,000,000

Traditionally the vendor group might sell the share capital for £1 and sell the £12,000,000 loan for its market value of £10,000,000.

For the acquiring group the loan would be a “second hand debt,” a chargeable asset under TCGA 1992 S.251(1). However, the acquiring group would ensure that Under-performing Subsidiary Ltd never triggered a disposal by repaying the debt.

Following FA 1996, the same purchase has materially adverse consequences for the acquirer since the subsidiary becomes connected. At the period end the debt is deemed to be payable in full at £12,000,000. The opening value is the price paid, £10,000,000, and a £2,000,000 taxable credit arises.

While Inland Revenue Tax Bulletin No. 29 June 1997 allows the discount recognition to be spread in certain cases, acquirers should avoid the situation wherever possible.

7.18.4.3.Debt for equity swaps – statutory relief

Earlier drafts of the rules adversely affected debt for equity swaps. The equity a lender swaps into can make it connected within S.87. If swapping lenders were denied bad debt relief, they might initiate formal insolvency proceedings.

Following representations, Sch.9 para.6(4) and 6(5) contain relief. Creditors not connected (under S.87) pre-swap are not precluded by para.6(3) from bad debt relief. Under para.6(4)(a) the shares issued must qualify as ordinary share capital. The bad debt relief is computed by comparing the original loan with the market value of the equity obtained.

The debtor is protected by Sch.9 para.5(3) from a taxable credit since S.87 applies, provided the creditor acquires enough shares to become connected. If the lender will not become connected then the debtor should ensure the swap is part of a "*relevant arrangement or compromise*" as defined in ICTA 1988 S.74(2) to avoid a taxable credit.

7.18.4.4.Venture capital and E.S.C. C28

The statutory rules give rise to a number of difficulties for venture capitalists. These would make the venture capitalist (VC) connected with the investee company and deny bad debt relief, thereby discouraging the provision of finance.

Some of the key issues addressed in Extra Statutory Concession C28 are:

- A VC often takes a non-controlling shareholding and makes a loan to the investee. The size of the loan could make the VC connected with the investee. C28 para.12 effectively extends the exemption of ICTA 1988 S.417(9) to finance providers who are not banks.

- Venture capital investors often come together as limited partnerships. Typically the limited partners only provide equity while the general partner provides the investee with both equity and debt. Attributing the rights of the limited partners to the general partner would often make it connected with the investee. C28 para.11 allows the rights of partners to be ignored when determining connectedness.

- VC's often subscribe for investee preference shares instead of or as well as making loans. In specified conditions C28 para.13 allows fixed rate preference shares to be disregarded in determining connectedness.

- The statutory debt/equity swap rules require the swap to be for ordinary share capital. C28 para.17 allows swaps into fixed rate preference shares.

7.19. Changes to the income tax rules

The new rules have no impact for income tax purposes except as specified in S.102 and Sch.13 regarding discounted securities.

7.19.1.Relevant discounted securities

Consistently using new language untainted by history, the draftsman introduces "*relevant discounted securities*" defined in Sch.13 para.3, summarised as follows:

- consider the security terms when issued
- assume redemption in accordance with the security's terms
- ignore under para.3(5) the possibility of redemption before maturity except if the holder has an option to require it. If so, apply the tests by looking at the earliest occasion when the holder may require redemption. (See section 7.3.2.3 for the tax avoidance opportunity)
- check if the redemption amount on maturity will (or may) exceed the issue price. If not, the security is not a relevant discounted security
- if the gain on redemption will or may exceed [$^{0.5}/_{12}$ x N x maturity value] where N is the number of whole or part months from issue date to redemption date, (or if N exceeds 360 then if the gain will or may exceed 15% of maturity value) then the security is a relevant discounted security, subject to the exemptions discussed in 7.19.1.2

The test catches contingent gains as well as certain gains, due to "*or might be an amount which would involve such a gain*" in Sch.13 para.3(1).

7.19.1.1.All gilt strips are relevant discounted securities

Sch.13 para.14(1) makes every gilt strip a relevant discounted security, without any arithmetical tests. Such certainty is commendable.

Otherwise if UK gilt yields fell below 0.5% pa (e.g. consider recent Yen interest rates) gilt strips would fall outside the relevant discounted securities test. Having divergent treatments, depending on yields, would be undesirable.

7.19.1.2.Exemptions from relevant discounted securities

Sch.13 para.3(2) lists several exclusions. Some are noteworthy.

7.19.1.2.1.Shares in a company

Many listed UK investment trusts have issued "zero dividend preference shares". As investments these resemble zero coupon bonds, but are legally preference shares. (With a debt free investment trust, a zero dividend preference share is as secure as a zero coupon bond.)

As shares, they remain within capital gains tax, so individual investors benefit from the annual capital gains exemption and from tapering.

7.19.1.2.2.Gilt edged securities that are not strips

This represents a 100% retreat from the original plan in May 1995 to charge individuals income tax on all gilt gains. See 7.8.

Accordingly, all gains (and losses) on gilts, apart from interest, continue to be exempt from income tax or capital gains tax.

7.19.1.2.3.Excluded indexed securities

These are defined in Sch.13 para.13 which looks very similar to the definition of asset linked debt in S.93. Upon a close reading of S.93(6) - S.93(13) and para.13(2) - para.13(8) there is no actual difference.

The only differences are in terminology to avoid using the phrase "loan relationship" in an income tax context.

7.19.1.2.4.Securities issued under the same prospectus

Where securities were issued under a prospectus, and were not relevant discounted securities when issued then further issues of securities under the same prospectus are also not relevant discounted securities, regardless of the discount on the later issue. Sch.13 para.3(2)(f)

This is a very practical relieving measure.

As an illustration, assume:

- on 1 January 1998 a company issues at par £100 million of 10% debentures redeemable 31 December 2007. The debentures are, of course, not relevant discounted securities.
- the prospectus permits the company at any time to issue a further £50 million of debentures, having identical rights, in every respect interchangeable with the earlier issue.

On 31 March 1998 the remaining £50 million are issued. Assume increased market interest rates, so the 31 March 1998 issue is at £94 per £100 nominal. Mathematically the second tranche discount (6% over 10 years) ensures a deep gain on maturity.

It would be commercially impractical for the first tranche to not be relevant discounted securities while the second tranche issued were. The two tranches would not be fungible, since ownership by individuals would have different tax consequences. Separate records would have to be kept of the two tranches, with added operating costs. Moreover, the trading liquidity as separate tranches would be lower than with a single £150 million fungible pool.

Sch.13 para.10 protects the Exchequer from abuse. It applies if the nominal value of the securities needing para.3(2)(f) exemption exceeds the nominal value of securities issued under the prospectus which are inherently not relevant discounted securities. (E.g. in the example, if the issue on 31 March exceeded £100 million.)

Where para.10 applies, all securities issued under the prospectus are treated as relevant discounted securities for any events (defined in para.10(3)) occurring after the threshold is transgressed. This is undesirable for existing investors, who originally purchased non-relevant discounted securities.

This matters for lawyers advising investors in an issue of non-relevant discounted securities. If the prospectus permits further issues greater in nominal amount, the lawyers should require a warranty from the issuer that any further issues will not infringe para.10.

7.19.2.Charge on realised discounts and related losses

Under Sch.13 para.1(1) a realised "*profit from the discount on a relevant discounted security*" suffers income tax under schedule D case III, or case IV for non-UK securities. Sch.13 para.6 integrates the charge with other tax rules applicable to trusts and estates. Para.12 integrates with ICTA 1988 S.739 and S.740. Para.11 prevents double counting by excluding the accrued interest scheme, since Sch.13 para.1(1) taxes the whole gain including accrued interest.

Despite the reference in para.1(1) to "*profit from the discount*" the computation in para.1(3) ignores the discount, simply comparing proceeds with acquisition cost. While the gain might derive from the discount, it may equally arise from market value fluctuations. Para.1(3) does not seek to distinguish; it just taxes proceeds less cost.

Consequently Sch.13 follows the deep gain rules in FA 1989 Sch.11, and not the deep discount security rules in ICTA 1988 Sch.4 which carefully taxed only the accruing discount while market price fluctuations fell within capital gains tax or were exempt for QCB's.

Making all relevant discounted securities profits taxable, rather than dissecting into taxable discount and non-taxable "other value fluctuations" considerably simplifies the calculations. Taxpayers, in the writer's view, are compensated by Sch.13 para.2 providing relief for realised losses.

Individuals and income tax paying companies can offset the loss against other income, para.2(1). However under Sch.13 para.6(4) trustees can only offset the loss against income from relevant discounted securities in the same or future years. The writer can discern no policy grounds for this discrimination against trustees.

Sch.13 para.7 ensures that general relief is not given for losses if a gain would have received the exemption given charities and pension funds. Such a loss can only be offset against relevant discounted security gains of the same year; carry forward is prohibited.

7.19.3. When are gains realised?

Under Sch.13 para.1(2)(a) the trigger is redemption or any earlier "transfer," defined in Sch.13 para.4(1) to include any transfer by way of sale, exchange, or gift. Death causes a notional market value transfer immediately prior to death (so the individual is chargeable, not his estate). Sch.13 para.4(3) prevents avoidance by a sale of only the beneficial interest. The usual rules regarding options and conditional contracts apply.

Sch.13 para.5 extends "redemption" to conversion into shares or other securities. The extension excludes exchanges covered by Sch.13 para.14 (stripping a gilt or reconstituting it).

7.19.4. Application to gilt strips

The government feared individuals using gilt strips to defer taxable interest income. Accordingly Sch.13 para.14(4) marks to market on 5 April each year all gilt strips held by an income tax payer, and taxes the resulting gain or loss.

The example below shows why Sch.13 para.4(4) was needed.

Investor A

He invests £1,000 into 7% coupon gilts, reinvesting all income for 20 years after paying 40% income tax. Assume no market fluctuations, and for simplicity all income tax being paid immediately.

The individual earns 7% gross, which after 40% income tax is 4.2%.

£1,000 compounded for 20 years at 4.2% becomes £2,276.96 post tax proceeds for investor A.

Investor B

He invests £1,000 into a gilt strip, implied yield of 7%, selling 20 years later.

Proceeds before tax from gilt strip £1,000 @ 7% for 20 years	£3,869.68

Cost	1,000.00
Gain	2,869.68
Tax @ 40%	1,147.87
Net proceeds to investor B after tax	**£2,721.81**

Investor B's enhancement is at the expense of the Exchequer, which receives no tax for 20 years.

While Sch.13 para.14(4) applies to gilt strips, there is no equivalent for individuals investing in corporate zero coupon bonds or stripped foreign government bonds. While such investors presently face credit risk or exchange risk respectively, the writer expects Sch.13 para.14(4) to be extended to stripped overseas government euro denominated bonds if the UK enters monetary union. Otherwise it will become vacuous.

7.19.4.1.Stripping by income tax payers

Sch.14 para.14(2) and para.14(3) repeat for income tax purposes the rules which apply to companies on stripping and reconstituting gilts which are discussed on page 52. However they are less precisely drafted.

Para.14(3) echoes S.95(3), but does not explicitly state that the acquisition cost of the reconstituted gilt equals the aggregate market value of the strips. However that is the only tenable reading. Similarly para.14(2) assumes that stripping constitutes a market value disposal of the gilt, whereas S.95(2)(a) explicitly legislates that. Again, for gilts the only tenable reading of para.14(2) is that the gilt undergoes a disposal.

7.20. Commencement Date

Notwithstanding S.105(1)(a) the full new system applies to accounting periods commencing after 1 April 1996. The straddling accounting period is subject to transitional rules that are not discussed in this thesis.

7.21. Minor and consequential amendments

Sch.14 contains many amendments, necessitated by the new language of "loan relationships" and "debits" and "credits." The general aim is to keep the underlying old law effect, except where changes are intended by the other parts of FA 1996. Accordingly, much of Sch.14 is not discussed in this thesis.

8. Interaction with Foreign Exchange rules

FA1996 amends the FA 1993 rules to simplify matters when both apply. E.g. they avoid separately tracking carried forward non-trade forex losses and non-trade interest debits.

8.1. No double charge

Sch.9 para.4(1) computes debits/credits disregarding any debits/credits the accounting method generates from exchange fluctuations.

Applying para.4(1) is straightforward if the loan relationship's foreign currency amount is constant. E.g. assume:

- The company borrows $100 on 1 January 1998
- Interest of $3.50 is payable every 30 June and 31 December
- The loan is repayable at $100 on 31 December 2007

Each year the only loan relationship debit is $7 interest expense, converted into sterling using an appropriate exchange rate e.g. year end spot rate, or average rate for the year.

Under Sch.9 para.4(2) exchange fluctuations on the $100 loan remain taxable / deductible under the 1993 foreign exchange rules.

The same principles apply when loan relationship amount varies in foreign currency. However the calculations are more complex.

FA 1993 S.127 was amended by FA 1996 Sch.14 para.67. The rules are illustrated below:

- dollar denominated zero coupon bond, owed by a company with a calendar year end
- company uses the year's average rate to translate income and expense items
- bond amounts and exchange rates are as follows

Date	$ liability	Spot rate	Year	Average rate
1/1/1998	$30	1.60		
31/12/1998	$32	1.65	1998	Say 1.62
31/12/1999	$35	1.58	1999	Say 1.63

Loan relationship calculations

1998 – loan relationship debit $2 at average rate 1.62 = £1.23

1999 – loan relationship debit $3 at average rate 1.63 = £1.84

Foreign exchange calculations

		Foreign currency	Rate	Local currency i.e. £
1998	Opening liability FA 1993 S.127(2)(a)	$30	1.60	18.75
	FA 1993 S.127(2)(b) local currency equivalent at each time immediately after the debt increases	$2	? use 1.62	1.23
				19.98
	FA 1993 S.127(2)(e) at end of accounting period	$32	1.65	19.39
	Taxable exchange gain as liability in £ has reduced FA 1993 S.127(4)(a)			**0.59**

		Foreign currency	Rate	Local currency i.e. £
1999	Opening liability FA 1993 S.127(2)(a)	$32	1.65	19.39
	FA 1993 S.127(2)(b) local currency equivalent at each time immediately after the debt increases	$3	? use 1.63	1.84
				21.23
	FA 1993 S.127(2)(e) at end of accounting period	$35	1.58	22.15
	Deductible exchange loss as liability in £ has increased FA 1993 S.127(4)(b)			**(0.92)**

Under FA 1993 S.127(1 B) the accruing discount constitutes an increase in the nominal amount of the debt. However FA 1996 did not amend the wording of S.127(2)(b). That subsection assumes a specific time when the nominal debt amount increases. This time matters, as one requires an exchange rate to use.

In reality the discount accrues over the entire accounting period. The way to make FA1993 S.127(2)(b) apply consistently is using the same rate as for translating the interest debit. The company used the average rate for 1998, 1.62, to translate the interest; therefore this rate is used for FA1993 S.127(2)(b) consistent with the $2 accruing evenly over 1998.

Conversely if the $2 interest debit were translated using the closing rate of 1.65 then the consistent assumption for FA1993 S.127(2)(b) has the debt increasing on 31 December 1998 and translates the $2 increase at 1.65.

Proceeding consistently ensures that the aggregate taxed under the loan relationship and foreign exchange rules equals the sterling economic outturn. E.g. for 1998 the interest debit £1.23 and the exchange gain £0.59 give a net £0.64 deductible. The economic loss is [$32 @1.65] less [$30 @ 1.60] = £0.64.

8.2. Non-trading exchange gains and losses

Sch.14, para.69 subsumes non-trading foreign exchange differences into their FA 1996 equivalents:

- a non-trading exchange gain is brought into account as if a non-trade loan relationship credit.
- a non-trading exchange loss is brought into account as a non-trade debit.

FA 1996 Sch.15 para.24 converts old non-trading exchange losses into brought forward non-trade debits governed by S. 83(3).

Sch.15 para.23 does the opposite, so a non-trade loan relationship deficit carries back against pre1 April 1996 exchange profits.

8.3. *Changes in classification*

Sch.14 para.70 changes the qualifying assets and liabilities definitions in FA 1993 S. 153.

S. 92 (convertible) or S. 93 (asset-linked debt) items are not qualifying assets for the foreign exchange rules.

The convertible liabilities exclusion in FA 1993 S.153(6) is repealed. Previously an intra-group currency liability could easily be kept outside the foreign exchange rules by making it convertible.

9. Interaction with financial instruments rules

FA 1996 amends the FA 1994 financial instruments rules, mainly to block a loophole.

9.1. No double charge

S.101(1) precludes a 1994 Financial Instruments charge on qualifying contracts if the debit or credit is recognised under the 1996 rules.

The change below requires this.

9.2. Debt contracts and options

FA1994 part IV chapter II introduced a new tax regime for interest rate derivatives and currency derivatives, outside the scope of this thesis. However, since capital gains on government securities and QCB's were still tax free, options over gilts or QCB's were left outside the FA1994 rules, and continued to be CGT free under TCGA 1992 S.115(1)(b).

A tax avoidance scheme involved entering into four options, achieving an interest equivalent return tax free, illustrated below:

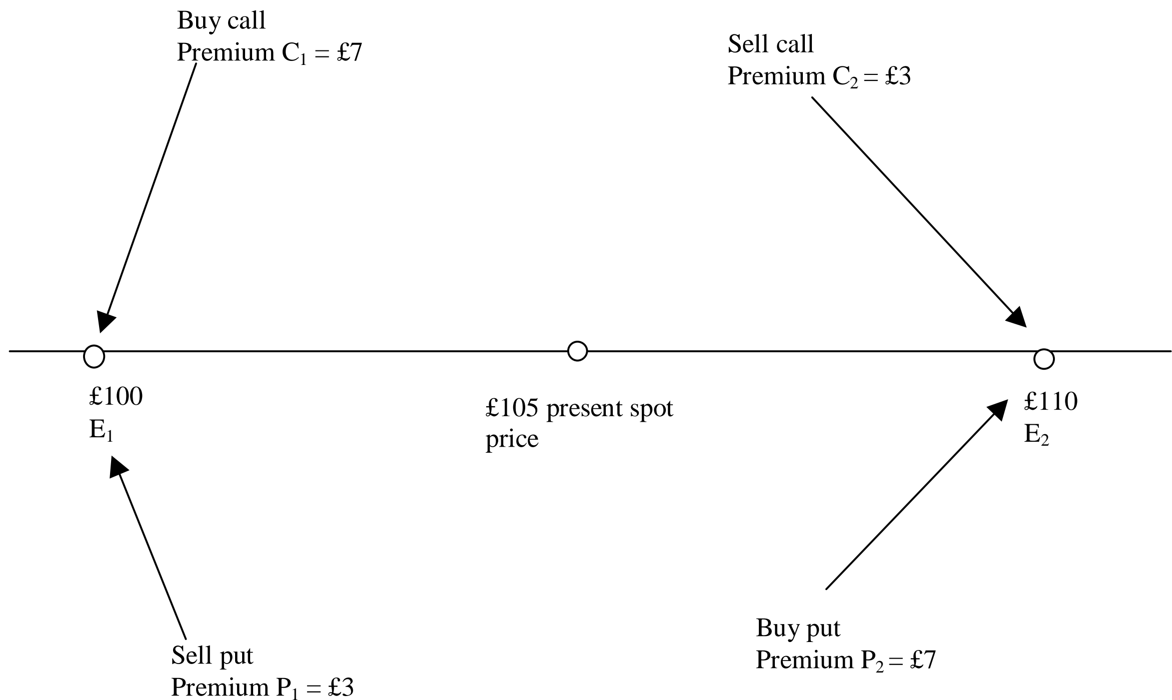
Consider a gilt priced at £105. The company transacts the following options exercisable in 12 months time.

1. Buy call exercisable at £100, paying premium of £7

2. Sell put exercisable at £100, receiving premium of £3

3. Sell call exercisable at £110, receiving premium of £3

4. Buy put exercisable at £110, paying premium of £7



The company's proceeds will be a fixed £10, i.e. E2-E1, regardless of the gilt's price in 12 months time.

The table below demonstrates this conclusively, using a full spectrum of future gilt prices.

Gilt price	(1) Bought £100 call	(2) Sold £100 put	(3) Sold £110 call	(4) Bought £110 put	Net company out-turn
99	0	(1)	0	11	**10**
103	3	0	0	7	**10**
107	7	0	0	3	**10**
111	11	0	(1)	0	**10**

The company's initial cost was £7+£7 (two options purchased) less £3+£3 proceeds (two options sold) making a net cost of £8. I.e. C1+P2-C2-P1

Fixed overall proceeds of £10 mean a net gain of £2 on investment of £8, i.e. 25%pa, risk free using these illustrative figures.

In reality, with an efficient options market, the prices C1, C2, P1, P2, E1 and E2 will produce an actual rate of return (ignoring transaction costs) equating a risk free interest rate e.g. that on Treasury bills. Transaction costs should be minimal.

Once the "gilt box scheme" became widely known, legislation was inevitable.

S.101(2) kills the scheme by making debt contracts qualifying contracts with a new FA1994 S.147A. Gains on qualifying contracts are taxable income. Sch.12 inserts a new S.150A into FA 1994 with detailed definitions.

10. Company Law and Accounting Aspects

Some commentators expressed concern that the changes might conflict with company law. The writer considers that such concerns were exaggerated.

10.1. Accounting methods legally available

10.1.1. Lower of cost or net realisable value

This method has long been used to value trading stock. In our context, it would be used to value creditor relationships held by a financial trader.

FA 1996 prohibits its use for tax purposes. The method is unduly prudent because it recognises declines in net realisable value in the accounts, but not increases.

This accounting method has been growing less popular in securities markets, especially with the changes in practice after "big bang" in 1986.

10.1.2. Accruals accounting for liabilities and assets

Such accounting is mandatory for liabilities following FRS4.[7] It would clearly be wrong to have a liability and not recognise any growth in that liability from the accrual of discount.

FRS4[7] does not apply to assets. However, in the writer's opinion, company law permits accruals accounting. A profit from accruing income is not distributable since it is unrealised.

10.1.3. Marking to Market

R v Inland Revenue Commissioners, ex parte S G Warburg & Co Ltd, 1994 STC, concerned an application for judicial review following a change from "lower of cost or market" (effectively net realisable value) to "mark to market". The court held that under accountancy practice in 1987, mark to market was not a valid method of stock valuation.

Such a finding would be unlikely today given changes in commercial practice and mark to market is now normal practice for securities dealers and other financial traders, when dealing with their trading assets and derivatives positions. UK company law expressly permits this in CA 1985 Sch.9 [Special Provisions for Banking Companies and Groups] para.34.

The "Alternative Accounting Rules" in CA 1985 Sch.4 para.31 were enacted to permit Current Cost Accounting, as in the now withdrawn Statement of Standard Accounting Practice number 16. In the context of loan relationships, they provide authority for marking loan relationships to market value, being an approximation of current cost. However, under these rules the uplift must go to revaluation reserve, released to the profit and loss account only on realisation.

Accounting Standards Committee Exposure Draft 55 addresses companies marking securities to market and taking the gain to profit and loss account. It concluded that this could be reconciled with the Companies Act by invoking the need to give "a true and fair view" which overrides specific CA 1985 accounting provisions.

10.2. Likely future accounting standards

The ASB[10] has suggested requiring companies to mark derivatives positions to market. The main intellectual argument against marking all derivatives positions to market is that often they hedge exposures on liabilities. Marking the derivative to market is arguably inappropriate unless the liability can also be marked to market (to record an opposite gain/loss if the derivative is an effective hedge).

The ASB[10] paper acknowledges this, and therefore proposes also marking liabilities to market. Companies would reflect market interest rate changes but not changes in their liabilities' market value arising from changes in the credit worthiness of the company itself.

Interestingly, this accounting proposal mirrors the tax concept of "fair value" of liabilities in S.85(6) discussed on page 44.

11. Conclusions

11.1. Is it fair?

The writer saw the 25 May 1995 Inland Revenue press release as an Inspector's "wish list," and regarded the original proposals as unfair.

With several cycles of changes before enactment of FA 1996, a fair balance has emerged.

- Many loopholes are blocked. More importantly, there is a coherent approach ensuring economic gains on debt are taxed.
- The taxpayer receives increased symmetry. E.g. losses on bonds are now deductible.

The calculations used are inherently logical. Archaic concepts (such as relief for "charges" only when paid) disappear.

11.2. Does it meet the original objectives?

The most important objective was to allow gilt stripping. This has been achieved.

The wider objective was to remove old, complex, piecemeal legislation and replace it with a coherent modern code dealing with debt and interest.

Despite the remaining complexity (much for anti-avoidance reasons), in the writer's opinion these objectives have been achieved.

11.3. What would the writer change?

The law continues to change, not least because tax advisors have been astute to exploit any loophole as with convertible debt.

Where the writer finds the new rules least satisfactory is bad debt. There is no logic to the denial of bad debt relief for losses on loans to connected companies. Also, the present rules contain many traps as discussed in the text.

12. Legislative Extracts

This section contains extracts from legislation for the convenience of readers. I have been selective in deciding what to conclude. Occasionally, for convenience I have included the legislation as amended.
Accordingly, the extracts included here should not be used for any purpose other than as an aid to reading the thesis.

12.1. Income and Corporation Taxes Act 1970

12.1.1.ICTA 1970 S.30

Provisions for preventing avoidance of surtax by sales cum dividend etc.

(1) Any individual upon whom notice is served by the Board requiring him to furnish a statement of and particulars relating to any assets in which, at any time during the period specified in the notice, he has had any beneficial interest, and in respect of which, within such period, either no income was received by him or the income received by him was less than the sum to which the income would have amounted if the income from such assets had accrued from day to day and been apportioned accordingly, shall, whether an assessment to surtax in respect of his total income has or has not been made for the relevant year or years of assessment, furnish such a statement and such particulars in the form and within the time (not being less than twenty-eight days) required by the notice.

(2) The Board may serve further notices whenever they consider it necessary for the purposes of this section until complete particulars have been furnished to their satisfaction.

(3) If it appears to the Board by reference to all the circumstances in relation to the assets of any such individual (including circumstances with respect to sales, purchases, dealings, contracts, arrangements, transfers or any other transactions relating to such assets) that the individual has thereby avoided, or would avoid, more than 10 per cent. of the amount of the surtax for any year which would have been payable in his case if the income from those assets had been deemed to accrue from day to day and had been apportioned accordingly and the income so deemed to have been apportioned to him had been treated as part of his total income for the purposes of surtax, then those assets shall be deemed to be assets to which subsection (4) below applies.

(4) For the purposes of assessment to surtax in the case of any such individual, the income from any assets to which this subsection applies shall be deemed to accrue from day to day and, in the case of the sale or transfer of any such assets by or to him, shall be deemed to have been received as and when it is deemed to have accrued:

Provided that an individual shall not be liable to be assessed to surtax under this section in respect of any such income if he proves to the satisfaction of the Board that the avoidance of surtax was exceptional and not systematic, and that there was not in his case in any of the three next preceding years any such avoidance of surtax as is described in the provisions of subsection (3) above.

(5) If any individual fails to furnish any statement or particulars required under this section, or if the Board are not satisfied with any statement or particulars furnished under this section, they may make an estimate of the amount of the income which, under the preceding provisions of this section, is to be deemed to form part of his total income for the purposes of surtax.

(6) For the purposes of this section " assets " means

(a) stocks or securities entitled to interest or dividend at a fixed rate only, not being stocks or securities the interest or dividend on which is dependent on the earnings of a company, and

(b) any other stocks or securities and any shares, if transactions in relation thereto have been effected by the individual otherwise than through a stock exchange in the United Kingdom and by a transfer on which ad valorem duty has been paid under the heading " Conveyance or Transfer on Sale " in Schedule 1 to the Stamp Act 1891.

12.2. Companies Act 1985

12.2.1. CA 1985 S.130

Application of share premiums

(1) If a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account called “the share premium account”.

(2) The share premium account may be applied by the company in paying up unissued shares to be allotted to members as fully paid bonus shares, or in writing off—

(a) the company’s preliminary expenses; or

(b) the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company,

or in providing for the premium payable on redemption of debentures of the company.

(3) Subject to this, the provisions of this Act relating to the reduction of a company’s share capital apply as if the share premium account were part of its paid up share capital.

(4) Sections 131 and 132 below give relief from the requirements of this section, and in those sections references to the issuing company are to the company issuing shares as above mentioned.

12.2.2. CA 1985 S.425

Power of company to compromise with creditors and members

(1) Where a compromise or arrangement is proposed between a company and its creditors, or any class of them, or between the company and its members, or any class of them, the court may on the application of the company or any creditor or member of it or, in the case of a company being wound up,or an administration order being in force in relation to a company, of the liquidator or administratororder a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the court directs.

(2) If a majority in number representing three-fourths in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting, agree to any compromise or arrangement, the compromise or arrangement, if sanctioned by the court, is binding on all creditors or the class of creditors or on the members or class of members (as the case may be), and also on the company or, in the case of a company in the course of being wound up, on the liquidator and contributories of the company.

(3) The court’s order under subsection (2) has no effect until an office copy of it has been delivered to the registrar of companies for registration; and a copy of every such order shall be annexed to every copy of the company’s memorandum issued after the order has been made or, in the case of a company not having a memorandum, of every copy so issued of the instrument constituting the company or defining its constitution.

(4) If a company makes default in complying with subsection (3), the company and every officer of it who is in default is liable to a fine.

(5) An order under subsection (1) pronounced in Scotland by the judge acting as vacation judge in pursuance of section 4 of the Administration of Justice (Scotland) Act 1933 is not subject to review, reduction, suspension or stay of execution.

(6) In this section and the next—

(a) “company” means any company liable to be wound up under this Act, and

(b) “arrangement” includes a reorganisation of the company’s share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods.

12.2.3. CA 1985 Sch.4 para.31

(1) Intangible fixed assets, other than goodwill, may be included at their current cost.

(2) Tangible fixed assets may be included at a market value determined as at the date of their last valuation or at their current cost.

(3) Investments of any description falling to be included under item B.III of either of the balance sheet formats set out in Part I of this Schedule may be included either—

(a) at a market value determined as at the date of their last valuation; or

(b) at a value determined on any basis which appears to the directors to be appropriate in the circumstances of the company;

but in the latter case particulars of the method of valuation adopted and of the reasons for adopting it shall be disclosed in a note to the accounts.

(4) Investments of any description falling to be included under item C.III of either of the balance sheet formats set out in Part I of this Schedule may be included at their current cost.

(5) Stocks may be included at their current cost.

12.2.4. CA 1985 Sch.9 para.34

(1) Subject to paragraph 33 above, the amount to be included in the balance sheet in respect of transferable securities not held as financial fixed assets may be the higher of their cost or their market value at the balance sheet date.

(2) The difference between the cost of any securities included in the balance sheet at a valuation under sub-paragraph (1) and their market value shall be shown (in aggregate) in the notes to the accounts.

12.3. Income And Corporation Taxes ACT 1988

12.3.1. ICTA 1988 S.7

Treatment of certain payments and repayment of income tax

(1) No payment made by a company resident in the United Kingdom shall be treated for any purpose of the Income Tax Acts as paid out of profits or gains brought into charge to income tax; nor shall any right or obligation under the Income Tax Acts to deduct income tax from any payment be affected by the fact that the recipient is a company not chargeable to income tax in respect of the payment.

(2) Subject to the provisions of the Corporation Tax Acts, where a company resident in the United Kingdom receives any payment on which it bears income tax by deduction, the income tax thereon shall be set off against any corporation tax assessable on the company …[2] for the accounting period in which that payment falls to be taken into account for corporation tax (or would fall to be taken into account but for any exemption from corporation tax); …[1]

(3) Subsection (2) above does not apply to a payment of relevant loan interest to which section 369 applies.

(4) References in this section to payments received by a company apply to any received by another person on behalf of or in trust for the company, but not to any received by the company on behalf of or in trust for another person.

(5) Effect shall be given to section 6(2), to that section as modified by subsection (2) above and by section 11(3) and, so far as exemptions from income tax conferred by the Corporation Tax Acts call for repayment of tax, to those exemptions by means of a claim.

(6) A claim for the purposes of subsection (5) above, so far as relating to subsection (2) above and section 11(3), shall be made by being included in a return in section 11 of the Management Act (corporation tax return) for the period to which the claim relates

(7) In subsection (6) above the reference to a claim being included in a return includes a reference to a claim being included by virtue of an amendment of the return

12.3.2. ICTA 1988 S.74

General rules as to deductions not allowable

(1)Subject to the provisions of the Tax Acts, in computing the amount of the profitsto be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of—

(*a*) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation;

(*b*) any disbursements or expenses of maintenance of the parties, their families or establishments, or any sums expended for any other domestic or private purposes distinct from the purposes of the trade, profession or vocation;

(*c*) the rent of the whole or any part of any dwelling-house or domestic offices, except any such part as is used for the purposes of the trade, profession or vocation, and where any such part is so used, the sum so deducted shall not, unless in any particular case it appears that having regard to all the circumstances some greater sum ought to be deducted, exceed two-thirds of the rent bona fide paid for that dwelling-house or those offices;

(*d*) any sum expended for repairs of premises occupied, or for the supply, repairs or alterations of any implements, utensils or articles employed, for the purposes of the trade, profession or vocation, beyond the sum actually expended for those purposes;

(*e*) any loss not connected with or arising out of the trade, profession or vocation;

(*f*) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade, profession or vocation, but so that this paragraph shall not be treated as disallowing the deduction of any interest;

(*g*) any capital employed in improvements of premises occupied for the purposes of the trade, profession or vocation;

(*h*) any interest which might have been made if any such sums as aforesaid had been laid out at interest;

(*j*) any debts except—

(i) a bad debt …;

(ii) a debt or part of a debt released by the creditor wholly and exclusively for the purposes of his trade, profession or vocation as part of a relevant arrangement or compromise; and

(iii) a doubtful debt to the extent estimated to be bad, meaning, in the case of the bankruptcy or insolvency of the debtor, the debt except to the extent that any amount may reasonably be expected to be received on the debt;

(*k*) any average loss beyond the actual amount of loss after adjustment;

(*l*) any sum recoverable under an insurance or contract of indemnity;

(*m*) any annuity or other annual payment (other than interest) payable out of the profits

(*n*) any interest paid to a person not resident in the United Kingdom if and so far as it is interest at more than a reasonable commercial rate;

(*o*) any interest in so far as the payment of that interest is or would be, otherwise than by virtue of section 375(2), either—

(i) a payment of interest to which section 369 applies, or

(ii) a payment of interest to which that section would apply but for section 373(5);(*p*) any royalty or other sum paid in respect of the user of a patent;

(2) In paragraph (*j*) of subsection (1) above "relevant arrangement or compromise" means—

(*a*) a voluntary arrangement which has taken effect under or by virtue of the Insolvency Act 1986 or the Insolvency (Northern Ireland) Order 1989; or

(*b*) a compromise or arrangement which has taken effect under section 425 of the Companies Act 1985 or Article 418 of the Companies (Northern Ireland) Order 1986.

12.3.3.ICTA 1988 S.77

Incidental costs of obtaining loan finance

(1) Subject to subsection (5) below, in computing the profitsto be charged under Case I or II of Schedule D there may be deducted the incidental costs of obtaining finance by means of a qualifying loan or the issue of qualifying loan stock or a qualifying security; and the incidental costs of obtaining finance by those means shall be treated for the purposes of section 75 as expenses of management.

(2) Subject to subsections (3) and (4) below, in this section—

(*a*) "a qualifying loan" and "qualifying loan stock" mean a loan or loan stock the interest on which is deductible—

(i) in computing for tax purposes the profitsof the person by whom the incidental costs in question are incurred; or

(ii) under section 338 against his total profits; and

(*b*) "qualifying security" means any deep discount security, as defined by paragraph 1 of Schedule 4, in respect of which the income elements, as defined by paragraph 4 of that Schedule, are deductible under paragraph 5(1) of that Schedule in computing the total profits of the company by which the incidental costs in question are incurred.

(3) Except as provided by subsection (4) below, a loan or loan stock which carries the right of conversion into or to the acquisition of—

(*a*) shares, or

(*b*) other securities not being a qualifying loan or qualifying loan stock,

is not a qualifying loan or qualifying loan stock if that right is exercisable before the expiry of the period of three years from the date when the loan was obtained or the stock issued.

(4) A loan or loan stock—

(*a*) which carries such a right as is referred to in subsection (3) above, and

(*b*) which by virtue of that subsection is not a qualifying loan or qualifying loan stock,

shall nevertheless be regarded as a qualifying loan or qualifying loan stock, as the case may be, if the right is not, or is not wholly, exercised before the expiry of the period of three years from the date when the loan was obtained or the stock was issued.

(5) For the purposes of the application of subsection (1) above in relation to a loan or loan stock which is a qualifying loan or qualifying loan stock by virtue of subsection (4) above—

(*a*) if the right referred to in subsection (4)(*a*) above is exercised as to part of the loan or stock within the period referred to in that subsection, only that proportion of the incidental costs of obtaining finance which corresponds to the proportion of the stock in respect of which the right is not exercised within that period shall be taken into account; and

(*b*) in so far as any of the incidental costs of obtaining finance are incurred before the expiry of the period referred to in subsection (4) above they shall be treated as incurred immediately after that period expires.

(6) In this section “the incidental costs of obtaining finance” means expenditure on fees, commissions, advertising, printing and other incidental matters (but not including stamp duty), being expenditure wholly and exclusively incurred for the purpose of obtaining the finance (whether or not it is in fact obtained), or of providing security for it or of repaying it.

(7) This section shall not be construed as affording relief—

(*a*) for any sums paid in consequence of, or for obtaining protection against, losses resulting from changes in the rate of exchange between different currencies; or

(*b*) for the cost of repaying a loan or loan stock or a qualifying security so far as attributable to its being repayable at a premium or to its having been obtained or issued at a discount.

(8) This section shall not apply for the purposes of corporation tax.

12.3.4. ICTA 1988 S.88A – S.88C

Debts of overseas governments etc

These provisions were repealed by FA 1996 and are not reproduced for brevity.

12.3.5. ICTA 1988 S.124

Interest on quoted Eurobonds

(1) Section 349(2) shall not apply to interest paid on any quoted Eurobond where—

(*a*) the person by or through whom the payment is made is not in the United Kingdom; or

(*b*) the payment is made by or through a person who is in the United Kingdom but either of the conditions mentioned in subsection (2) below is satisfied.

(2) The conditions are—

(*a*) that a person who—

(i) is not resident in the United Kingdom, and

(ii) beneficially owns the quoted Eurobond

is beneficially entitled to the interest;

(*b*) that the quoted Eurobond is held in a recognised clearing system.(3) The Board may by regulations provide that subsection (1)(*b*) above shall be taken not to apply to a payment of interest unless—

(*a*) the person by or through whom the payment is made (the relevant payer) has received a declaration confirming that one of the conditions of subsection (2) above is satisfied, or

(*b*) they have issued a notice to the relevant payer stating that they consider that one (or both) of those conditions is satisfied.(4) Regulations under subsection (3) above may—

(*a*) impose requirements as to—

(i) the contents of any declaration to be made in accordance with regulations under subsection (3)(*a*) above,

(ii) the form and manner in which any declaration is to be provided in accordance with any such regulations, and

(iii) the keeping and production to, or to an officer of, the Board of any document in which any such declaration is contained;

(*b*) make provision for any such declaration to be made by the person entitled to the interest (or, as the case may be, the depositary for the recognised clearing system) or by such other person as may be prescribed by the regulations;

(*c*) require the relevant payer to consider the accuracy of any such declaration;

(*d*) make provision for notice s to be issued by the Board to such persons as may be described in the regulations where the Board consider that—

(i) one (or both) of the conditions of subsection (2) above, or

(ii) neither of those conditions

is satisfied in relation to interest paid on any holding of quoted Eurobond s;

(*e*) make provision with respect to the furnishing of information by relevant payers, including the inspection of books and other records on behalf of the Board;

(*f*) require relevant payers to deliver returns setting out particulars of payments made by them to which subsection (1)(*b*) above applies and the names and addresses of the persons entitled to them;

(*g*) contain such supplementary, incidental, consequential or transitional provisions as appear to the Board to be necessary or expedient.(6) In this section—

“quoted Eurobond” means a security which—

(*a*) is issued by a company;

(*b*) is listedon a recognised stock exchange;

(*c*) is in bearer form; and

(*d*) carries a right to interest; …

12.3.6.ICTA 1988 S.349

Payments not out of profits or gains brought into charge to income tax, and annual interest

(1) Where—

(*a*) any annuity or other annual payment charged with tax under Case III of Schedule D, not being interest; or

(*b*) any royalty or other sum paid in respect of the user of a patent;…

(*c*) …

is not payable or not wholly payable out of profits or gains brought into charge to income tax, the person by or through whom any payment thereof is made shall, on making the payment, deduct out of it a sum representing the amount of income tax thereon.

This subsection does not apply to any payment to which section 687 applies or to any payment which is a relevant payment for the purposes of Chapter VIIA of Part IV.

(2) Subject to subsection (3) below and to any other provision to the contrary in the Income Tax Acts, where any yearly interest of money chargeable to tax under Case III of Schedule D (as that Schedule has effect apart from the modification made for the purposes of corporation tax by section 18(3A)) is paid—

(*a*) otherwise than in a fiduciary or representative capacity, by a company (other than a building society)or local authority; or

(*b*) by or on behalf of a partnership of which a company is a member; or

(*c*) by any person to another person whose usual place of abode is outside the United Kingdom;

the person by or through whom the payment is made shall, on making the payment, deduct out of it a sum representing the amount of income tax thereon for the year in which the payment is made.

(3) Subsection (2) above does not apply—

(*a*) to interest payable on an advance from a bank, if at the time when the interest is paid the person beneficially entitled to the interest is within the charge to corporation tax as respects the interest ; or

(*b*) to interest paid by a bank in the ordinary course of its business; or

(*ba*) to interest paid on deposits with the National Savings Bank; or

(*c*) to any payment to which section 124 applies; or

(d) to any payment to which section 369 …applies;or

(e) to any payment which is a relevant payment for the purposes of Chapter VIIA of Part IV; or

(f) to any payment in respect of which a liability to deduct income tax is imposed by section 480A(1); or

(*g*) to any payment in respect of which a liability to deduct income tax would be imposed by section 480A(1) if conditions prescribed by regulations under section 480B were not fulfilled;or

(h) to any payment in respect of which a liability to deduct income tax would, but for section 481(5)(*k*), be imposed by section 480A(1).…

(3AA) In this section “bank” has the meaning given by section 840A.

(3AB) An order under section 840A(1)(*d*) designating an organisation as a bank for the purposes of paragraph (*a*) of subsection (3) above may provide that that paragraph shall apply to the organisation as if the words from “if” to the end were omitted.

(3A) Subject to subsection (3B) below and to any other provision to the contrary in the Income Tax Acts, where—

(*a*) any dividend or interest is paid in respect of a security issued by a building society other than a qualifying certificate of deposit and other than a qualifying deposit right

(*b*) the security was listed, or capable of being listed, on a recognised stock exchange at the time the dividend or interest became payable,

the person by or through whom the payment is made shall, on making the payment, deduct out of it a sum representing the amount of income tax thereon for the year in which the payment is made.(3B) Subsection (3A) above does not apply to any payment to which section 124 applies.(4) In this section

“dividend” has the same meaning as in section 477A;

“qualifying certificate of deposit” means a certificate of deposit, as defined in section 56(5), under which—

(*a*) the amount payable by the issuing society, exclusive of interest, is not less than £50,000 (or, for a deposit denominated in foreign currency, not less than the equivalent of £50,000 at the time when the deposit is made), and

(*b*) the obligation of the society to pay that amount arises after a period of not more than five years beginning with the date on which the deposit is made; and“qualifying deposit right” means a right to receive an amount (with or without interest) in pursuance of a deposit of money, where—

(*a*) the right subsists under an arrangement falling within section 56A,

(*b*) no certificate of deposit, as defined in section 56(5), has been issued in respect of the right at the time the dividend or interest concerned is paid, and

(*c*) the conditions set out in paragraphs (*a*) and (*b*) in the definition of “qualifying certificate of deposit” apply; and“security” includes share.

12.3.7.ICTA 1988 S.393A

Losses: set off against profits of the same, or an earlier, accounting period

(1) Subject to section 492(3), where in any accounting period ending on or after 1st April 1991 a company carrying on a trade incurs a loss in the trade, then, subject to subsection (3) below, the company may make a claim requiring that the loss be set off for the purposes of corporation tax against profits (of whatever description)—

(*a*) of that accounting period, and

(*b*) if the company was then carrying on the trade and the claim so requires, of preceding accounting periods falling wholly or partly within the period specified in subsection (2) below;

and, subject to that subsection and to any relief for an earlier loss, the profits of any of those accounting periods shall then be treated as reduced by the amount of the loss, or by so much of that amount as cannot be relieved under this subsection against profits of a later accounting period.

(2) The period referred to in paragraph (*b*) of subsection (1) above is (subject to subsection (2A) below) the period of twelve monthsimmediately preceding the accounting period in which the loss is incurred; but the amount of the reduction that may be made under that subsection in the profits of an accounting period falling partly before the beginning of that period shall not exceed a part of those profits proportionate to the part of the accounting period falling within that period.

(2A) This section shall have effect in relation to any loss to which this subsection applies as if, in subsection (2) above, the words 'three years' were substituted for the words 'twelve months'.(2B) Where a company ceases to carry on a trade at any time, subsection (2A) above applies to the following—

(*a*) the whole of any loss incurred in that trade by that company in an accounting period beginning twelve months or less before that time; and

(*b*) the part of any loss incurred in that trade by that company in an accounting period ending, but not beginning, in that twelve months which is proportionate to the part of that accounting period falling within that twelve months.

(2C) Where—

(*a*) a loss is incurred by a company in a ring fence trade carried on by that company, and

(*b*) the accounting period in which the loss is incurred is an accounting period for which an allowance under section 62A of the 1990 Act (demolition costs relating to offshore machinery or plant) is made to that company,

subsection (2A) above applies to so much of the amount of that loss not falling within subsection (2B) above as does not exceed the amount of that allowance.(3) Subsection (1) above shall not apply to trade s falling within Case V of Schedule D; and a loss incurred in a trade in any accounting period shall not be relieved under that subsection unless—

(*a*) the trade is one carried on in the exercise of functions conferred by or under any enactment (including an enactment contained in a local or private Act), or

(*b*)forthat accounting period the trade was being carried on on a commercial basis and with a view to the realisation of gain in the trade or in any larger undertaking of which the trade formed part;

but this subsection is without prejudice to section 397.

(4) For the purposes of subsection (3) above—

(*a*) where at any time a trade is carried on so as to afford a reasonable expectation of gain, it shall be treated as being carried on at that time with a view to the realisation of gain; and(*b*) where in an accounting period there is a change in the manner in which a trade is being carried on, it shall be treated as having throughout the accounting period been carried on in the way in which it was being carried on by the end of that period.

(5) A claim under subsection (1) above may require that capital allowance s in respect of the trade, being allowances that fall—

(*a*) to be made to the company by way of discharge or repayment of tax, and

(*b*) to be so made for an accounting period ending on or after 1st April 1991,

shall (so far as they cannot be otherwise taken into account so as to reduce or relieve any charge to corporation tax in respect of that, or any earlier, accounting period) be added to the loss incurred by the company in that accounting period or, if the company has not incurred a loss in the period, shall be treated as a loss so incurred.

(6) For the purposes of subsection (5) above, the allowances for any period shall not be treated as including amounts carried forward from an earlier period.

(7)Subject to subsection (7A) below,where a company ceases to carry on a trade, subsection (9) of section 393 shall apply in computing for the purposes of this section a loss in the trade in an accounting period ending with the cessation, or ending

at any time in the twelve months immediately preceding the cessation,as it applies in computing a loss in an accounting period for the purposes of subsection (1) of that section.

(7A) For the purposes of this section where—

(*a*) subsection (7) above has effect for computing the loss for any accounting period, and

(*b*) that accounting period is one beginning before the beginning of the twelve months mentioned in that subsection,

the part of that loss that is not the part falling within subsection (2B)(*b*) above shall be treated as reduced (without any corresponding increase in the part of the loss that does fall within subsection (2B)(*b*) above) by an amount equal to so much of the aggregate of the charges on income treated as expenses by virtue of subsection (7) above as is proportionate to the part of the accounting period that does not fall within those twelve months.(8) Relief shall not be given by virtue of subsection (1)(*b*) above in respect of a loss incurred in a trade so as to interfere with any relief under section 338 in respect of payments made wholly and exclusively for the purposes of that trade.

(9) For the purposes of this section—

(*a*) the amount of a loss incurred in a trade in an accounting period shall be computed in the same way as trading income from the trade in that period would have been computed;

(*b*) “trading income” means, in relation to any trade, the income which falls or would fall to be included in respect of the trade in the total profits of the company; and

(*c*) references to a company carrying on a trade refer to the company carrying it on so as to be within the charge to corporation tax in respect of it.

(10) A claim under subsection (1) above may only be made within the period of two years immediately following the accounting period in which the loss is incurred or within such further period as the Board may allow.

(11) In any case where—

(*a*) by virtue of section 62B of the 1990 Act (post-cessation abandonment expenditure related to offshore machinery or plant) the qualifying expenditure of the company for the chargeable period related to the cessation of its ring fence trade is treated as increased by any amount, or

(*b*) by virtue of section 109 of that Act (restoration expenditure incurred after cessation of trade of mineral extraction) any expenditure is treated as qualifying expenditure incurred by the company on the last day on which it carried on the trade,

then, in relation to any claim under subsection (1) above to the extent that it relates to an increase falling within paragraph (*a*) above or to expenditure falling within paragraph (*b*) above, subsection (10) above shall have effect with the substitution of “five years” for “two years”.(12) In this section “ring fence” has the same meaning as in section 62A of the 1990 Act.

12.3.8.ICTA 1988 S.397

Restriction of relief in case of farming and market gardening

(1) Any loss incurred in a trade of farming or market gardening shall be excluded from section 380 if in each of the prior five years a loss , computed without regard to capital allowance s,was incurred in carrying on that trade; …

(2) Any loss incurred in any accounting period by a company in carrying on a trade of farming or market gardening shall be excluded from section 393A(1)if a loss, computed without regard to capital allowance s, was incurred in carrying on that trade in that accounting period, and in each of the chargeable period s wholly or partly comprised in the prior five years.

12.3.9.ICTA 1988 S.401

Relief for pre-trading expenditure

(1) Where a person incurs expenditure for the purposes of a trade, profession or vocation before the time when he begins to carry it on and the expenditure—

(*a*) is incurred not more than seven years before that time; and

(*b*) is not allowable as a deduction in computing his profitsfrom the trade, profession or vocation for the purposes of Case I or II of Schedule D but would have been so allowable if incurred after that time,

the expenditure shall be treated as incurred on the day on which the trade, profession or vocation is first carried on by him

(1AA) Subsection (1) above shall not apply to any expenditure in relation to which any debit falls, or (but for subsection (1AB) below) would fall, to be brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships).(1AB) Where, in the case of any company—

(*a*) a non-trading debit is given for any accounting period for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships), and

(*b*) an election for the purposes of this section is made by that company with respect to that debit within the period of 2 years beginning with the end of that accounting period,

that debit shall not be brought into account for the purposes of that Chapter as a non-trading debit for that period, but subsection (1AC) below shall apply instead.(1AC) If a company—

(*a*) begins to carry on a trade within the period of seven years after the end of the accounting period for which a non-trading debit is given for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships),

(*b*) that debit is such that, if it had been given for the accounting period in which the company begins to carry on that trade, it would have been brought into account by reference to that trade in accordance with section 82(2) of that Act (trading debits and credits), and

(*c*) an election is or has been made with respect to that debit under subsection (1AB) above,

that debit shall be treated for the purposes of that Chapter as if it were a debit for the accounting period in which the company begins to carry on the trade and shall be brought into account for that period in accordance with section 82(2) of that Act.

(1A) Where—

(a) a company pays any charge on income at a time before it begins to carry on any trade, and

(b) the payment is made wholly and exclusively for the purposes of that trade,

that payment, to the extent that it is not deducted otherwise than by virtue of this section from any profits, shall be treated for the purposes of corporation tax as paid on the day on which the trade is first carried on by the company.

12.3.10.ICTA 1988 S.402

Surrender of relief between members of groups and consortia

(1) Subject to and in accordance with this Chapter and section 492(8), relief for trading losses and other amounts eligible for relief from corporation tax may, in the cases set out in subsections (2) and (3) below, be surrendered by a company ("the surrendering company") and, on the making of a claim by another company ("the claimant company") may be allowed to the claimant company by way of a relief from corporation tax called "group relief".

(2) Group relief shall be available in a case where the surrendering company and the claimant company are both members of the same group.

A claim made by virtue of this subsection is referred to as a "group claim".

(3) Group relief shall also be available in the case of a surrendering company and a claimant company either where one of them is a member of a consortium and the other is—

(*a*) a trading company which is owned by the consortium and which is not a 75 per cent subsidiary of any company; or

(*b*) a trading company—

(i) which is a 90 per cent subsidiary of a holding company which is owned by the consortium; and

(ii) which is not a 75 per cent subsidiary of a company other than the holding company; or

(*c*) a holding company which is owned by the consortium and which is not a 75 per cent subsidiary of any company;

or, in accordance with section 406, where one of them is a member of a group of companies and the other is owned by a consortium and another company is a member of both the group and the consortium.

A claim made by virtue of this subsection is referred to as "a consortium claim".

(4) A consortium claim shall not be made if the share in the consortium of the member in the relevant accounting period of the surrendering company (or, where that company is a trading company falling within subsection (3)(*b*) above, its holding company) is nil or if a profit on a sale of the share capital of the other company or its holding company which the member owns would be treated as a trading receipt of that member.

(5) Subject to the provisions of this Chapter, two or more claimant companies may make claims relating to the same surrendering company, and to the same accounting period of that surrendering company.

(6) A payment for group relief—

(*a*) shall not be taken into account in computing profits or losses of either company for corporation tax purposes, and

(*b*) shall not for any of the purposes of the Corporation Tax Acts be regarded as a distribution or a charge on income;

and in this subsection “a payment for group relief” means a payment made by the claimant company to the surrendering company in pursuance of an agreement between them as respects an amount surrendered by way of group relief, being a payment not exceeding that amount.

12.3.11.ICTA 1988 S.407

Relationship between group relief and other relief

(1) Group relief for an accounting period shall be allowed as a deduction against the claimant company’s total profits for the period—

(*a*) before reduction by any relief derived from a subsequent accounting period, but

(*b*) as reduced by any other relief from tax (including relief in respect of charges on income under section 338(1)of this Act or by virtue of section 83 of, or paragraph 4 of Schedule 11 to, the Finance Act 1996 (non-trading deficits) determined on the assumption that the company makes all relevant claims under section 393A(1)of this Act and section 145(3) of the 1990 Act(set-off of capital allowance s against total profits).

(2) For the purposes of this section “relief derived from a subsequent accounting period” means—

(*a*) relief under section 393A(1)(*b*)in respect of a loss incurred in an accounting period after the accounting period the profits of which are being computed; and

(*b*) relief under section 145(3) of the 1990 Actin respect of capital allowance s falling to be made for an accounting period after the accounting period the profits of which are being computed;and(*c*) relief in pursuance of a claim under section 83(2) of, or paragraph 4 of Schedule 11 to, the Finance Act 1996 (non-trading deficits) in respect of any deficit for a deficit period after the accounting period the profits of which are being computed.(3) The reductions to be made in total profits of an accounting period against which any relief derived from a subsequent accounting period is to be set off shall include any group relief for that first-mentioned accounting period.

12.3.12.ICTA 1988 S.416

Meaning of “associated company” and “control”

(1) For the purposes of this Part, …, a company is to be treated as another’s “associated company” at a given time if, at that time or at any other time within one year previously, one of the two has control of the other, or both are under the control of the same person or persons.

(2) For the purposes of this Part, a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company’s affairs, and in particular, but without prejudice to the generality of the preceding words, if he possesses or is entitled to acquire—

(*a*) the greater part of the share capital or issued share capital of the company or of the voting power in the company; or

(*b*) such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed; or

(*c*) such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.

(3) Where two or more persons together satisfy any of the conditions of subsection (2) above, they shall be taken to have control of the company.

(4) For the purposes of subsection (2) above a person shall be treated as entitled to acquire anything which he is entitled to acquire at a future date, or will at a future date be entitled to acquire.

(5) For the purposes of subsections (2) and (3) above, there shall be attributed to any person any rights or powers of a nominee for him, that is to say, any rights or powers which another person possesses on his behalf or may be required to exercise on his direction or behalf.

(6) For the purposes of subsections (2) and (3) above, there may also be attributed to any person all the rights and powers of any company of which he has, or he and associates of his have, control or any two or more such companies, or of any associate of his or of any two or more associates of his, including those attributed to a company or associate under subsection (5) above, but not those attributed to an associate under this subsection; and such attributions shall be made under this subsection as will result in the company being treated as under the control of five or fewer participators if it can be so treated.

12.3.13. ICTA 1988 S.417

Meaning of "participator", "associate", "director" and "loan creditor"

(1) For the purposes of this Part, a "participator" is, in relation to any company, a person having a share or interest in the capital or income of the company, and, without prejudice to the generality of the preceding words, includes—

(*a*) any person who possesses, or is entitled to acquire, share capital or voting rights in the company;

(*b*) any loan creditor of the company;

(*c*) any person who possesses, or is entitled to acquire, a right to receive or participate in distribution s of the company (construing "distribution s" without regard to section 418) or any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption; and

(*d*) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit.

In this subsection references to being entitled to do anything apply where a person is presently entitled to do it at a future date, or will at a future date be entitled to do it.

(2) The provisions of subsection (1) above are without prejudice to any particular provision of this Part requiring a participator in one company to be treated as being also a participator in another company.

(3) For the purposes of this Part "associate" means, in relation to a participator—

(*a*) any relative or partner of the participator;

(*b*) the trustee or trustees of any settlement in relation to which the participator is, or any relative of his (living or dead) is or was, a settlor ("settlement" and "settlor" having here the same meaning as in Chapter IA of Part XV (see section 660G(1) and (2)) and

(*c*) where the participator is interested in any shares or obligations of the company which are subject to any trust, or are part of the estate of a deceased person—

(i) the trustee or trustees of the settlement concerned or, as the case may be, the personal representatives of the deceased; and

(ii) if the participator is a company, any other company interested in those shares or obligations;

and has a corresponding meaning in relation to a person other than a participator.

(4) In subsection (3) above "relative" means husband or wife, parent or remoter forebear, child or remoter issue, or brother or sister.

(5) For the purposes of this Part "director" includes any person occupying the position of director by whatever name called, any person in accordance with whose directions or instructions the directors are accustomed to act, and any person who—

(*a*) is a manager of the company or otherwise concerned in the management of the company's trade or business, and

(*b*) is, either on his own or with one or more associates, the beneficial owner of, or able, directly or through the medium of other companies or by any other indirect means, to control 20 per cent or over of the ordinary share capital of the company.

(6) In subsection (5)(*b*) above the expression "either on his own or with one or more associates" requires a person to be treated as owning or, as the case may be, controlling what any associate owns or controls, even if he does not own or control share capital on his own.

(7) Subject to subsection (9) below, for the purposes of this Part "loan creditor", in relation to a company, means a creditor in respect of any debt incurred by the company—

(*a*) for any money borrowed or capital assets acquired by the company; or

(*b*) for any right to receive income created in favour of the company; or

(*c*) for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt (including any premium thereon);

or in respect of any redeemable loan capital issued by the company.

(8) Subject to subsection (9) below, a person who is not the creditor in respect of any debt or loan capital to which subsection (7) above applies but nevertheless has a beneficial interest therein shall, to the extent of that interest, be treated for the purposes of this Part as a loan creditor in respect of that debt or loan capital.

(9) A person carrying on a business of banking shall not be deemed to be a loan creditor in respect of any loan capital or debt issued or incurred by the company for money lent by him to the company in the ordinary course of that business.

12.3.14.ICTA 1988 S.703 – S.708

These deal with tax advantages derived from transactions in securities. They have not been reproduced for brevity.

12.3.15.ICTA 1988 S.709

Meaning of “tax advantage” and other expressions

(1) In this Chapter “tax advantage” means a relief or increased relief from, or repayment or increased repayment of, tax, or the avoidance or reduction of a charge to tax or an assessment to tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is effected by receipts accruing in such a way that the recipient does not pay or bear tax on them, or by a deduction in computing profits or gains.

The remainder of ICTA 1988 S.709 has been omitted for brevity.

12.3.16.ICTA 1988 S.730

Transfers of income arising from securities

(1) Where in any chargeable period the owner of any securities (“the owner”) sells or transfers the right to receive any interest payable (whether before or after the sale or transfer) in respect of the securities without selling or transferring the securities, then, for all the purposes of the Tax Acts, that interest, whether it would or would not be chargeable to tax apart from the provisions of this section—

(*a*) shall be deemed to be the income of the owner or, in a case where the owner is not the beneficial owner of the securities and some other person (“a beneficiary”) is beneficially entitled to the income arising from the securities, the income of the beneficiary, and

(*b*) shall be deemed to be the income of the owner or beneficiary for that chargeable period, and

(*c*) shall not be deemed to be the income of any other person.

(2) For the purposes of subsection (1) above, in the case of a sale or other realisation the proceeds of which are chargeable to tax by virtue of section 18(3B)the interest so deemed to be the income of the owner or beneficiary shall be deemed to be equal in amount to the amount of those proceeds.

(3) Nothing in subsection (1) above shall affect any provision of this Act authorising or requiring the deduction of income tax—

(*a*) from any interest which, under that subsection, is deemed to be the income of the owner or beneficiary, or

(*b*) from the proceeds of any subsequent sale or other realisation of the right to receive that interest;

but the proceeds of any such subsequent sale or other realisation shall not, for any of the purposes of the Tax Acts, be deemed to be the income of the seller or the person on whose behalf the right is otherwise realised.

(4) Where—

(*a*) the securities are of such a character that the interest payable in respect thereof may be paid without deduction of income tax, and

(*b*) the owner or beneficiary does not show that the proceeds of any sale or other realisation of the right to receive the interest which is deemed to be his income by virtue of this section have been charged to tax by virtue of section 18(3B)

then the owner or beneficiary shall be chargeable to tax under Case VI of Schedule D in respect of that interest, but shall be entitled to credit for any tax which that interest is shown to have borne.

(5) For the purposes of subsection (4) above, in any case where, if the interest had been chargeable under Case IV or Case V of Schedule D, the computation of tax would have been made by reference to the amount received in the United Kingdom, the tax under Case VI shall be computed on the full amount of the sums which have been or will be received in the United Kingdom in the year of assessment or any subsequent year in which the owner remains the owner of the securities.

(6) In relation to corporation tax, subsections (4) and (5) above shall not apply but, subject to the provisions of the Tax Acts about distribution s, the owner or beneficiary shall, in respect of any interest which is deemed to be his income by virtue of this section, be chargeable to corporation tax under Case VI of Schedule D unless he shows that the proceeds of any sale or other realisation of the right to receive that interest have been charged to tax by virtue of section 18(3B)

(7) In this section—

“interest” includes dividends, annuities and shares of annuities, and

“securities” includes stocks and shares.

(8) The Board may by notice require any person to furnish them within such time as they may direct (not being less than 28 days), in respect of all securities of which he was the owner at any time during the period specified in the notice, with such particulars as they consider necessary for the purposes of this section and for the purpose of discovering whether—

(*a*) tax has been borne in respect of the interest on all those securities; or

(*b*) the proceeds of any sale or other realisation of the right to receive the interest on the securities have been charged to tax by virtue of section 18(3B)

12.3.17.ICTA 1988 S.730A

Treatment of price differential on sale and repurchase of securities

(1) Subject to subsection (8) below, this section applies where—

(*a*) a person (“the original owner”) has transferred any securities to another person (“the interim holder”) under an agreement to sell them;

(*b*) the original owner or a person connected with him is required to buy them back either—

(i) in pursuance of an obligation to do so imposed by that agreement or by any related agreement, or

(ii) in consequence of the exercise of an option acquired under that agreement or any related agreement;

and

(*c*) the sale price and the repurchase price are different.

(2) The difference between the sale price and the repurchase price shall be treated for the purposes of the Tax Acts—

(*a*) where the repurchase price is more than the sale price, as a payment of interest made by the repurchaser on a deemed loan from the interim holder of an amount equal to the sale price; and

(*b*) where the sale price is more than the repurchase price, as a payment of interest made by the interim holder on a deemed loan from the repurchaser of an amount equal to the repurchase price.

(3) Where any amount is deemed under subsection (2) above to be a payment of interest, that payment shall be deemed for the purposes of the Tax Acts to be one that becomes due at the time when the repurchase price becomes due and, accordingly, is treated as paid when that price is paid.

(4) Where any amount is deemed under subsection (2) above to be a payment of interest, the repurchase price shall be treated for the purposes of the Tax Acts (other than this section and sections 737A and 737C) and (in cases where section 263A of the 1992 Act does not apply) for the purposes of the 1992 Act—

(*a*) in a case falling within paragraph (*a*) of that subsection, as reduced by the amount of the deemed payment; and

(*b*) in a case falling within paragraph (*b*) of that subsection, as increased by the amount of the deemed payment.

(5) For the purposes of section 209(2)(*d*) and (*da*) any amount which is deemed under subsection (2)(*a*) above to be a payment of interest shall be deemed to be interest in respect of securities issued by the repurchaser and held by the interim holder.

(6) For the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships)—

(*a*) interest deemed by virtue of subsection (2) above to be paid or received by any company shall be deemed to be interest under a loan relationship; and

(*b*) the debits and credits falling to be brought into account for the purposes of that Chapter so far as they relate to the deemed interest shall be those given by the use in relation to the deemed interest of an authorised accruals basis of accounting.(6A) Any question whether debits or credits brought into account in accordance with subsection (6) above in relation to any company—

(*a*) are to be brought into account under section 82(2) of the Finance Act 1996 (trading loan relationships), or

(*b*) are to be treated as non-trading debits or credits,

shall be determined (subject to Schedule 11 to that Act (insurance companies)) according to the extent (if any) to which the company is a party to the repurchase in the course of activities forming an integral part of a trade carried on by the company.(7) The Treasury may by regulations provide for any amount which is deemed under subsection (2) above to be received as a payment of interest to be treated, in such circumstances and to such extent as may be described in the regulations, as comprised in income that is eligible for relief from tax by virtue of section 438, 592(2), 608(2)(*a*), 613(4), 614(2),(3) or (4), 620(6) or 643(2).

(8) Except where regulations under section 737E otherwise provide, this section does not apply if—

(*a*) the agreement or agreements under which provision is made for the sale and repurchase are not such as would be entered into by persons dealing with each other at arm’s length; or

(*b*) all of the benefits or risks arising from fluctuations, before the repurchase takes place, in the market value of the securities sold accrue to, or fall on, the interim holder.

(9) In this section references to the repurchase price are to be construed—

(*a*) in cases where section 737A applies, and

(*b*) in cases where section 737A would apply if it were in force in relation to the securities in question,

as references to the repurchase price which is or, as the case may be, would be applicable by virtue of section 737C(3)(*b*),(9) or (11)(*c*).

12.3.18.ICTA 1988 S.730C

Exchanges of gilts: traders etc

This was inserted by FA 1996 Sch.40 para.7, see page 185.

12.3.19.ICTA 1988 S.737A

Sale and repurchase of securities: deemed manufactured payments

(1) This section applies where on or after the appointed day a person (the transferor) agrees to sell any securities, and under the same or any related agreement the transferor or another person connected with him—

(*a*) is required to buy back the securities, or

(*b*) acquires an option, which he subsequently exercises, to buy back the securities;

but this section does not apply unless the conditions set out in subsection (2) below are fulfilled.

(2) The conditions are that—

(*a*) as a result of the transaction, a dividend which becomes payable in respect of the securities is receivable otherwise than by the transferor,

(b) …

(*c*) there is no requirement under any agreement mentioned in subsection (1) above for a person to pay to the transferor on or before the relevant date an amount representative of the dividend, and

(*d*) it is reasonable to assume that, in arriving at the repurchase price of the securities, account was taken of the fact that the dividend is receivable otherwise than by the transferor.

(3) For the purposes of subsection (2) above the relevant date is the date when the repurchase price of the securities becomes due.

(4) Where it is a person connected with the transferor who is required to buy back the securities, or who acquires the option to buy them back, references in the following provisions of this section to the transferor shall be construed as references to the connected person.

(5) Where this section applies, … Schedule 23A and dividend manufacturing regulations shall apply as if—

(*a*) the relevant person were required, under the arrangements for the transfer of the securities, to pay to the transferor an amount representative of the dividend mentioned in subsection (2)(*a*) above,

(*b*) a payment were made by that person to the transferor in discharge of that requirement, and

(*c*) the payment were made on the date when the repurchase price of the securities becomes due.

(6) In subsection (5) above "the relevant person" means—

(*a*) where subsection (1)(*a*) above applies, the person from whom the transferor is required to buy back the securities;

(*b*) where subsection (1)(*b*) above applies, the person from whom the transferor has the right to buy back the securities;

and in that subsection "dividend manufacturing regulations" means regulations under Schedule 23A (whenever made).

12.3.20.ICTA 1988 S.739

Prevention of avoidance of income tax

(1) Subject to section 747(4)(*b*), the following provisions of this section shall have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfer of assets by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the United Kingdom.

(1A) Nothing in subsection (1) above shall be taken to imply that the provisions of subsections (2) and (3) apply only if —

(*a*) the individual in question was ordinarily resident in the United Kingdom at the time when the transfer was made; or

(*b*) the avoiding of liability to income tax is the purpose, or one of the purposes, for which the transfer was effected.(2) Where by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled outside the United Kingdom which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise, that income shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.

(3) Where, whether before or after any such transfer, such an individual receives or is entitled to receive any capital sum the payment of which is in any way connected with the transfer or any associated operation, any income which, by virtue or in consequence of the transfer, either alone or in conjunction with associated operations, has become the income of a person resident or domiciled outside the United Kingdom shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.

(4) In subsection (3) above "capital sum" means, subject to subsection (5) below—

(*a*) any sum paid or payable by way of loan or repayment of a loan, and

(*b*) any other sum paid or payable otherwise than as income, being a sum which is not paid or payable for full consideration in money or money's worth.

(5) For the purposes of subsection (3) above, there shall be treated as a capital sum which an individual receives or is entitled to receive any sum which a third person receives or is entitled to receive at the individual's direction or by virtue of the assignment by him of his right to receive it.

(6) Income shall not by virtue of subsection (3) above be deemed to be that of an individual for any year of assessment by reason only of his having received a sum by way of loan if that sum has been wholly repaid before the beginning of that year.

12.3.21. ICTA 1988 S.740

Liability of non-transferors

(1) This section has effect where—

(*a*) by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom; and

(*b*) an individual ordinarily resident in the United Kingdom who is not liable to tax under section 739 by reference to the transfer receives a benefit provided out of assets which are available for the purpose by virtue or in consequence of the transfer or of any associated operations.

(2) Subject to the provisions of this section, the amount or value of any such benefit as is mentioned in subsection (1) above, if not otherwise chargeable to income tax in the hands of the recipient, shall—

(*a*) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year;

(*b*) to the extent to which it is not by virtue of this subsection treated as his income for that year and falls within the amount of relevant income of the next following year of assessment, be treated for those purposes as his income for the next following year,

and so on for subsequent years, taking the reference in paragraph (*b*) to the year mentioned in paragraph (*a*) as a reference to that and any other year before the subsequent year in question.

(3) Subject to subsection (7) below and section 744(1), the relevant income of a year of assessment, in relation to an individual, is any income which arises in that year to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of the transfer or associated operations referred to in subsection (1) above can directly or indirectly be used for providing a benefit for the individual or for enabling a benefit to be provided for him.

(4) Income tax chargeable by virtue of this section shall be charged under Case VI of Schedule D.

(5) An individual who is domiciled outside the United Kingdom shall not, in respect of any benefit not received in the United Kingdom, be chargeable to tax under this section by reference to relevant income which is such that if he had received it he would not, by reason of his being so domiciled, have been chargeable to income tax in respect of it; and subsections (6) to (9) of section 65 shall apply for the purposes of this subsection as they would apply for the purposes of subsection (5) of that section if the benefit were income arising from possessions outside the United Kingdom.

(6) Where—

(*a*) the whole or part of the benefit received by an individual in a year of assessment is a capital payment within the meaning of section 87 or 89(2) of the 1992 Act(chargeable gain s: non-resident and migrant settlements)(because not falling within the amount of relevant income referred to in paragraph (*a*) of subsection (2) above); and

(*b*) chargeable gain s are by reason of that payment treated under either of those sections as accruing to him in that or a subsequent year,

paragraph (*b*) of that subsection shall apply in relation to any year of assessment ("a year of charge") after one in which chargeable gain s have been so treated as accruing to him as if a part of the amount or value of the benefit corresponding to the amount of those gains had been treated under that subsection as his income for a year of assessment before the year of charge.

(7) This section applies irrespective of when the transfer or associated operations referred to in subsection (1) above took place, but applies only to relevant income arising on or after 10th March 1981.

12.3.22. ICTA 1988 S.770

Sales etc at an undervalue or overvalue

This section contained the basic UK transfer pricing legislation. It has since been replaced when the transfer pricing legislation was modernised in 1998, and is not reproduced to save space.

12.3.23.ICTA 1988 S.787

Restriction of relief for payments of interest

(1) Relief shall not be given to any person under any provision of the Tax Acts in respect of any payment of interest if a scheme has been effected or arrangements have been made (whether before or after the time when the payment is made) such that the sole or main benefit that might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief.

(2) In this section "relief" means relief by way of deduction in computing profits or gains or deduction or set off against income or total profits.

(3) Where the relief is claimed by virtue of section 83(2)(b) of the Finance Act 1996 (claim to treat non-trading deficit as eligible for group relief)any question under this section as to what benefit might be expected to accrue from the transaction in question shall be determined by reference to the claimant company and the surrendering company taken together.

12.3.24.ICTA 1988 S.797

Limits on credit: corporation tax

(1) The amount of the credit for foreign tax which under any arrangements is to be allowed against corporation tax in respect of any income or chargeable gain ("the relevant income or gain") shall not exceed the corporation tax attributable to the relevant income or gain, determined in accordance with subsections (2) and (3) below.

(2) Subject to subsection (3) below, the amount of corporation tax attributable to the relevant income or gain shall be treated as equal to such proportion of the amount of that income or gain as corresponds to the rate of corporation tax payable by the company (before any credit under this Part) on its income or chargeable gain s for the accounting period in which the income arises or the gain accrues ("the relevant accounting period").

(3) Where in the relevant accounting period there is any deduction to be made for charges on income, expenses of management or other amounts which can be deducted from or set against or treated as reducing profits of more than one description—

(*a*) the company may for the purposes of this section allocate the deduction in such amounts and to such of its profits for that period as it thinks fit; and

(*b*) the amount of the relevant income or gain shall be treated for the purposes of subsection (2) above as reduced or, as the case may be, extinguished by so much (if any) of the deduction as is allocated to it.

(3A) Where, in a case to which section 797A does not apply, a company has a non-trading deficit on its loan relationships for the relevant accounting period, then for the purposes of subsection (3) above that deficit shall be treated, to the extent that it is an amount to which a claim under—

(*a*) subsection (2)(*a*) of section 83 of the Finance Act 1996 (deficit set against current year profits), or

(*b*) paragraph 4(2) of Schedule 11 to that Act (set-off of deficits in the case of insurance companies),

relates, as an amount that can in that period be set against profits of any description but can be allocated in accordance with subsection (3) above only to the profits against which it is set off in pursuance of the claim.(3B) For the purposes of subsection (3) above, where—

(*a*) section 797A does not apply in the case of any company, and

(*b*) any amount is carried forward to the relevant accounting period in pursuance of a claim under subsection (2)(*d*) of section 83 of the Finance Act 1996 ...

then that amount must be allocated to non-trading profits of the company for that period (so far as they are sufficient for the purpose) and cannot be allocated to any other profits.(4) Where in accordance with section 239 any advance corporation tax falls to be set against the company's liability to corporation tax on its profits (within the meaning of that section) for the relevant accounting period—

(*a*) so far as that liability relates to the relevant income or gain, it shall be taken to be reduced by the amount of the credit for foreign tax attributable to that income or gain, as determined in accordance with subsections (2) and (3) above; and

(*b*) the amount of advance corporation tax which may be set against that liability, so far as it relates to the relevant income or gain, shall not exceed whichever is the lower of the limits specified in subsection (5) below;

and section 239(2) shall have effect in relation only to so much of the profits of the company chargeable to corporation tax for that period as does not include the relevant income or gain.

(5) In relation to an amount of income or gain in respect of which the company's liability to corporation tax is taken to be reduced as mentioned in paragraph (*a*) of subsection (4) above, the limits referred to in paragraph (*b*) of that subsection are—

(*a*) the limit which would apply under section 239(2) if that amount of income or gain were the company's only income or gain for the relevant accounting period; and

(*b*) the amount of corporation tax for which, after taking account of that reduction, the company is liable in respect of that amount of income or gain.

(6) In this section "non-trading profits" has the same meaning as in paragraph 4 of Schedule 8 to the Finance Act 1996.

12.3.25. ICTA 1988 S.797A

Foreign tax on interest brought into account as a non-trading credit

This was inserted by FA 1996 Sch.14 para.43, see page 181.

12.3.26. ICTA 1988 S.807A

Disposals and acquisitions of company loan relationships with or without interest

This was inserted by FA 1996 Sch.14 para.46, see page 182.

12.3.27. ICTA 1988 S.832

Interpretation of the Tax Acts

(1) In the Tax Acts, except in so far as the context otherwise requires—

…

(3) Except so far as the context otherwise requires, in the Tax Acts, and in any enactment passed after 12th March 1970 which by any express provision is to be construed as one with the Tax Acts, the Corporation Tax Acts or the Income Tax Acts, "tax", where neither income tax nor corporation tax is specified, means either of those taxes.

(4) Subsection (3) above is without prejudice to the provisions of section 9 which apply income tax law for certain purposes of corporation tax, and accordingly the employment of "income tax" rather than "tax" in any provision of the Tax Acts is not a conclusive indication that that provision is not applied to corporation tax by that section.

12.3.28. ICTA 1988 S.839

Connected persons

(1) For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, any question whether a person is connected with another shall be determined in accordance with the following provisions of this section (any provision that one person is connected with another being taken to mean that they are connected with one another).

(2) A person is connected with an individual if that person is the individual's wife or husband, or is a relative, or the wife or husband of a relative, of the individual or of the individual's wife or husband.

(3) A person, in his capacity as trustee of a settlement, is connected with—

(*a*) any individual who in relation to the settlement is a settlor,

(*b*) any person who is connected with such an individual, and

(*c*) any body corporate which is connected with that settlement.

In this subsection "settlement" and "settlor" have the same meaning as in Chapter IA of Part XV (see section 660G(1) and (2)).(3A) For the purpose of subsection (3) above a body corporate is connected with a settlement if—

(*a*) it is a close company (or only not a close company because it is not resident in the United Kingdom) and the participators include the trustees of the settlement; or

(*b*) it is controlled (within the meaning of section 840) by a company falling within paragraph (*a*) above.(4) Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership, and with the wife or husband or relative of any individual with whom he is in partnership.

(5) A company is connected with another company—

(*a*) if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other; or

(*b*) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

(6) A company is connected with another person if that person has control of it or if that person and persons connected with him together have control of it.

(7) Any two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.

(8) In this section—

“company” includes any body corporate or unincorporated association, but does not include a partnership, and this section shall apply in relation to any unit trust scheme as if the scheme were a company and as if the rights of the unit holder s were shares in the company;

“control” shall be construed in accordance with section 416; and

“relative” means brother, sister, ancestor or lineal descendant.

12.3.29.ICTA 1988 SCHEDULE 4

Deep discount securities

12.3.29.1.ICTA 1988 Sch.4 para.1

Interpretation

(1) For the purposes of this Schedule—

(a) “adjusted issue price”, in relation to any security in a particular income period, is the aggregate of the issue price of the security and the income elements for all previous income periods;

(b) “the amount payable on redemption” does not include any amount payable by way of interest;

(c) “a deep discount”, in relation to any redeemable security, means a discount which—

(i) represents more than 15 per cent of the amount payable on redemption of that security; or

(ii) is 15 per cent or less, but exceeds half Y per cent of the amount so payable (where Y is the number of complete years between the date of issue of the security and the redemption date);

(d) subject to sub-paragraph (2) below, “a deep discount security” means any redeemable security which has been issued by a company, after 13th March 1984, at a deep discount, other than—

(i) a share in the company;

(ii) a security in respect of which the amount payable on redemption is determined by reference to the movement of the retail prices index or any similar general index of prices which is published by, or by an agent of, the government of any territory outside the United Kingdom; or

(iii) a security the whole or part of which, by virtue of section 209(2)(c), is a “distribution”;

(dd) “a deep discount security” also means any redeemable security which has been issued by a public body (at whatever time) at a deep discount, other than—

(i) a security such as is mentioned in paragraph (d)(ii) above;

(ii) a security falling within sub-paragraph (5),(6) or (7) below;

(e) “a discount” means any amount by which the issue price of a redeemable security is less than the amount payable on redemption of that security;

(f) “income period” means—

(i) in the case of a security carrying a right to interest, any period to which a payment of interest which falls to be made in respect of the security is attributable; and

(ii) in any other case, any year ending immediately before the anniversary of the issue of the security or any period of less than a year which begins on the issue or on such an anniversary and ends on the redemption date;

(g) “the redemption date” in relation to any redeemable security, means the earliest date on which, under the terms on which the security is issued, the holder of the security will be entitled to require it to be redeemed by the company or the public bodywhich issued it;

(h) “yield to maturity”, in relation to any security, means a rate (expressed as a percentage) such that if a sum equal to the issue price of the security were to be invested at that rate on the assumption that—

(i) the rate would be applied on a compounding bases at the end of each income period; and

(ii) the amount of any interest attributable to an income period would be deducted after applying the rate,

the value of that sum at the redemption date would be equal to the amount payable on redemption of the security; and

(j) “chargeable security” has the meaning given by paragraph 2(5) below.

(1A) Notwithstanding anything in sub-paragraph (1) above, for the purposes of this Schedule a security is not a deep discount security if—

(a) it was issued by a company on or after 1st August 1990, and

(b) under the terms of issue it can be converted into share capital in a company (whether or not the company is the one which issued the security).(1B) Notwithstanding anything in sub-paragraph (1) above, for the purposes of this Schedule a security is not a deep discount security if—

(a) it was issued on or after 1st August 1990, and

(b) under the terms of issue, there is more than one date on which the holder will be entitled to require it to be redeemed by the company or the public body which issued it.(2) Where securities which were issued on or before 13th March 1984 have been exchanged at any time after that date for new securities which would be deep discount securities but for this sub-paragraph, the new securities shall not be treated as deep discount securities if—

(a) the old securities would not have been deep discount securities if they had been issued after 13th March 1984;

(b) the date which is the redemption date in relation to the new securities is not later than the date which was the redemption date in relation to the old securities; and

(c) the amount payable on redemption of the new securities does not exceed the amount which would have been payable on redemption of the old securities.

This sub-paragraph applies only in the case of securities issued by a company.(3) For the purposes of this Schedule, a security comprised in any letter of allotment or similar instrument shall be treated as issued unless the right to the security conferred by the letter or instrument remains provisional until accepted, and there has been no acceptance.

(4) For the purposes of this Schedule a public body is any of the following which is not a company—

(a) a government, whether of the United Kingdom or elsewhere;

(b) a public or local authority, whether in the United Kingdom or elsewhere.(5) A security falls within this sub-paragraph if it is a gilt-edged security and—

(a) it was issued before 14th March 1989, or

(b) it was issued on or after that date but was issued under the same prospectus as any gilt-edged security issued before that date.(6) A security falls within this sub-paragraph if it is a gilt-edged security and—

(a) it was issued under a prospectus under which no securities were issued before 14th March 1989,

(b) it was issued otherwise than on the occasion of the original issue under the prospectus, and

(c) all the securities issued on the occasion of the original issue under the prospectus are gilt-edged securities which are not deep discount securities.(7) A security falls within this sub-paragraph if it is not a gilt-edged security and was issued (at whatever time) under the same prospectus as any other security which was issued before the security in question and

which is not a deep discount security.(8) For the purposes of this Schedule “gilt-edged security” has the same meaning as it has for the purposes of the 1992 Act.

12.3.29.2.ICTA 1988 Sch.4 para.2

Charge to tax after acquisition of certain securities

(1) This sub-paragraph applies to deep discount securities issued by a company on or after 19th March 1985 where one or both of the following applies—

(a) immediately before the issue the assets held by the company included relevant securities with a value equal to at least 75 per cent of the value of all the assets held by it;

(b) the terms of issue of the deep discount securities are determined by the company by reference to (though not necessarily in such a way that they reflect) the terms of issue of relevant securities which are held by the company when the deep discount securities are issued or which it intends to acquire later.

(2) This sub-paragraph applies to deep discount securities issued by a company where—

(a) sub-paragraph (1) above would apply if the references to relevant securities included references to United Kingdom corporate bonds; and

(b) the company acquired those bonds on or after their issue (by another company) in circumstances where sub-paragraph (1) above would have applied if they had been deep discount securities.

(3) This sub-paragraph applies to deep discount securities of a particular kind issued by a company and in the case of which—

(a) neither of the preceding sub-paragraphs applies; and

(b) at any time in the first income period of the securities of that kind the assets held by the company include relevant securities with a value equal to at least 75 per cent of the value of all the assets held by it.

(4) This sub-paragraph applies to deep discount securities issued by a company where either—

(a) they are issued on a conversion to which section 132 of the 1992 Act applies of old securities; or

(b) they are issued by a company in exchange for old securities in circumstances in which section 135(3) of the 1992 Act applies or are treated as so issued by virtue of section 136(1)of the Act;

and in this sub-paragraph “old securities” means deep discount securities to which sub-paragraph (1),(2) or (3) above or this sub-paragraph applies, except that securities to which sub-paragraph (3) above applies are not old securities unless sub-paragraph (3)(b) has been fulfilled in their case by the time the conversion or exchange concerned takes place.

(5) In the following provisions of this Schedule “chargeable security” means a deep discount security to which any of the preceding sub-paragraphs applies.

(6) In this paragraph—

“relevant securities” means securities within the meaning of section 710, but excluding United Kingdom corporate bonds;

“terms of issue” includes terms relating to amounts payable on redemption or by way of interest, or to times of payment of such amounts; and

“value” in relation to assets means the price they might reasonable be expected to fetch on a sale in the open market.

(7) For the purposes of this paragraph—

(a) a company holds assets if it has a beneficial interest in them and acquires them if it acquires such an interest in them; and

(b) securities are of the same kind if they are treated as being of the same kind by the practice of a stock exchange, or would be so treated if dealt with on a stock exchange.

(8) In this paragraph “United Kingdom corporate bonds” means securities—

(a) issued by a company resident in the United Kingdom at the time of issue;

(b) the debt on which represents and has at all times represented a normal commercial loan, as defined in paragraph 1(5) of Schedule 18; and

(c) which are expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling.

(9) For the purposes of sub-paragraph (8)(c) above—

(a) a security shall not be regarded as expressed in sterling if the amount of sterling falls to be determined by reference to the value at any time of any other currency or asset; and

(b) a provision for redemption in a currency other than sterling but at the rate of exchange prevailing at redemption shall be disregarded.

12.3.29.3.ICTA 1988 Sch.4 para.3

(1) Where a person acquires a chargeable security, the chargeable amount shall be treated as income chargeable to tax under Case III or IV (as the case may be) of Schedule D on each of the following occasions—

(a) the end of each income period to fall within the period of ownership;

(b) the end of any income period which ends but does not begin in the period of ownership.

(2) In sub-paragraph (1) above “the chargeable amount” means—

(a) where paragraph (a) applies, an amount equal to the income element for the income period;

(b) where paragraph (b) applies, an amount equal to the income element for the part of the income period falling within the period of ownership.

(3) The income chargeable shall (notwithstanding anything in sections 64 to 67) be taken into account in computing tax charged for the year of assessment in which the occasion concerned occurs.

12.3.29.4.ICTA 1988 Sch.4 para.4

Charge to tax on disposal of securities

(1) On the disposal by any person of any deep discount security—

(a) an amount which represents the accrued income attributable to the period between his acquisition and disposal of the security (the “period of ownership”), less any amount or amounts treated as income by virtue of paragraph 3 above, shall be treated as income chargeable to tax under Case III or, as may be, Case IV of Schedule D; and

(b) the tax shall (notwithstanding anything in sections 64 to 67 but subject to sub-paragraph (5) below) be computed on the income so arising from any disposal made in the year of assessment.

(2) The amount which represents the accrued income attributable to any period of ownership is the aggregate of the income elements for each income period or part of an income period in the period of ownership.

(3) In relation to any security, the income element for any income period shall be determined by applying the formula—

$$\frac{A \times B}{100} - C$$

where—

A is the adjusted issue price;

B is the yield to maturity; and

C is the amount of interest (if any) attributable to the income period.

(4) The income element for any period (the “short period”) falling within an income period shall be determined by applying the formula—

$$\frac{P}{Y} \times I$$

where—

I is the income element for the income period in which the short period falls;

P is the number of days in the short period; and

Y is the number of days in that income period.

12.3.29.5.ICTA 1988 Sch.4 para.5

Deduction of income element from total profits of company and allowance as charge on income

(1) In computing the corporation tax chargeable for any accounting period of a company which has issued any deep discount security, the income element in respect of that security for any income period ending in or with that accounting period shall be allowed as a deduction against the total profits of the company for the accounting period as reduced by any relief other than group relief.

(2) The income element for any income period ending in or with an accounting period of a company which has issued a deep discount security shall be treated for the purposes of the Corporation Tax Acts, other than those of section 338(1), as a charge on income paid by the company in the accounting period.

(3) No income element in respect of any deep discount security shall be so allowed or treated unless—

(a) the cost of paying so much of the amount payable on redemption as represents the discount is ultimately borne by the company;

(b) the income element would not otherwise be deductible in computing the issuing company's profits or any description of those profits for purposes of corporation tax; and

(c) at least one of the conditions mentioned in sub-paragraph (4) below is satisfied.

(4) The conditions are—

(a) that the company exists wholly or mainly for the purpose of carrying on a trade;

(b) that the deep discount security was issued wholly and exclusively to raise money for purposes of a trade carried on by the company;

(c) that the company is an investment company.

(5) Where, on redemption of any deep discount security, any part of the amount payable on redemption is, by virtue of section 209(2)(d),(da)and (e), a distribution of the company, sub-paragraphs (1) and (2) above shall not apply to any income element in respect of that security.

(6) Relief shall not be given under any provision of the Tax Acts in respect of any income element if (at any time) a scheme has been effected or arrangements have been made such that the sole or main benefit that might be expected to accrue to the company from the issue of the security in question is the obtaining of a reduction in tax liability by means of that relief.

(7) In sub-paragraph (6) above "relief" means relief by way of deduction in computing profits or gains or deduction or set-off against income or total profits; and where the relief is claimed by virtue of section 403(7) any question under this paragraph as to what benefit might be expected to accrue from the transaction in question shall be determined by reference to the claimant company and the surrendering company taken together.

12.3.29.6.ICTA 1988 Sch.4 para.7

Disposals

(1) Subject to sub-paragraphs (2) and (3) below, there is a disposal of a deep discount security for the purposes of this Schedule if there would be such a disposal for the purposes of the 1992 Act.

(2) Notwithstanding anything in section 62(1)(b)of that Act (no deemed disposal on death), where the assets of which a deceased person was competent to dispose include any deep discount security that security shall, for the purposes of this Schedule, be deemed to have been disposed of by the deceased immediately before his death.

(3) In any case where—

(a) there is a conversion of securities to which section 132 of the 1992 Act applies and those securities include deep discount securities; or

(b) securities including deep discount securities are exchanged (or by virtue of section 136(1)of that Act are treated as exchanged) for other securities in circumstances in which section 135(3)of that Act applies,

then the securities converted or exchanged shall (subject to sub-paragraph (4) below and notwithstanding section 127of that Act) be treated for the purposes of the charge to tax under paragraph 4 above as having been disposed of immediately before the time of the conversion, or, as the case may be, the exchange, by the person who was the beneficial owner of the securities at that time.

(4) Where a person would (but for this sub-paragraph) be treated by sub-paragraph (3) above as having, for the purposes of paragraph 4 above, disposed of deep discount securities, other than chargeable securities, which are converted into, or exchanged for, other deep discount securities—

(a) he shall not be so treated—

(i) if the date which is the redemption date in relation to the new securities is not later than the date which was the redemption date in relation to the converted or exchanged securities; and

(ii) no consideration is given for the conversion or exchange other than the new securities; but

(b) the amount of the accrued income attributable to his period of ownership of the converted or exchanged securities (including any amount added by virtue of the previous operation of this paragraph) shall be added to the amount of the accrued income attributable to his period of ownership of the new securities.

12.3.29.7.ICTA 1988 Sch.4 para.9

Securities issued and owned by associated companies or group companies

(1) Where a deep discount security issued by a company is at any time beneficially owned by another company which is—

(a) an associated company (within the meaning of section 416) of the issuing company; or

(b) a member of a group of companies of which the issuing company is also a member;

paragraph 5(1) and (2) above shall apply to any linked income element with the addition, after the words “the accounting period” of the words “in which the security is redeemed”.

(2) In this paragraph “linked income element” means the income element in respect of the security in question for any income period in which the security is at any time beneficially owned by the other company.

(3) For the purposes of this paragraph, two companies shall be deemed to be members of a group of companies if one is a 51 per cent subsidiary of the other or both are 51 per cent subsidiaries of a third company.

12.3.29.8.ICTA 1988 Sch.4 para.10

Close companies

(1) Where a deep discount security issued by a close company is at any time beneficially owned by—

(a) a participator in the company;

(b) an associate of such a participator; or

(c) a company of which such a participator has control,

paragraph 5(1) and (2) above shall apply to any linked income element with the addition, after the words “the accounting period”, of the words “in which the security is redeemed”.

(2) In sub-paragraph (1) above “linked income element” means the income element in respect of the security in question for any income period in which the security is at any time beneficially owned by a person mentioned in that sub-paragraph.

(3) …

(4) In this paragraph—

“associate” has the meaning given in section 417(3) and (4);

“control” shall be construed in accordance with section 416(2) to (6); and

“participator” means a person who is, in relation to a company, a participator for the purposes of Part XI (by virtue of section 417) other than a person who is a participator for those purposes by virtue only of his holding a deep discount security issued by the company.

(5) In determining whether a person who carries on a business of banking is a participator in a company for the purposes of this paragraph, there shall be disregarded any securities of the company acquired by him in the ordinary course of his business.

12.3.29.9.ICTA 1988 Sch.4 para.11

Early redemption

(1) Where any deep discount security issued by a companyis redeemed before the redemption date by the company which issued it, paragraphs 4, 5, 7(1) and (2) and 8 to 10 above shall have effect subject to the provisions of this paragraph.

(2) The accrued income attributable to the period between the acquisition of the security by the person who, immediately before its redemption, was the beneficial owner of the security and its redemption shall be the amount paid to him on redemption of the security less the issue price of the security or, in a case where he did not acquire it on its issue, less the aggregate of—

(a) the issue price; and

(b) the accrued income attributable to the period beginning with the issue, and ending with his acquisition, of the security;

and, if in either case paragraph 3 above applies, less also an amount equal to the chargeable amount (within the meaning of that paragraph).

(3) The deduction allowed under paragraph 5(1) above in relation to the accounting period in which the deep discount security is redeemed shall be the amount paid by the company on redemption less the aggregate of—

(a) the issue price of the security; and

(b) the accrued income attributable to the period beginning with the issue of the security and ending with the last income period to end in or with the accounting period of the company which precedes that in which the security is redeemed.

(4) Where paragraph 9 or 10 above has applied to the deep discount security at any time, the amount mentioned in sub-paragraph (3)(b) above shall not include any linked income element (within the meaning of that paragraph).

(5) Where the aggregate mentioned in sub-paragraph (3) above exceeds the amount paid by the company on redemption of the security, the amount of the excess or, if it is less, the amount mentioned in paragraph (b) of that sub-paragraph shall be treated as income of the company—

(a) arising in the accounting period in which the security is redeemed; and

(b) chargeable to tax under Case VI of Schedule D.

(6) Where a resolution is passed, an order made or any other act takes place for the winding up of a company which has issued a deep discount security before the security is redeemed, this paragraph shall have effect in relation to any payment made in respect of the security in the course of the winding up as if the payment were made on redemption.

12.3.29.10.ICTA 1988 Sch.4 para.11B

Issue price

(1) This paragraph applies where—

(a) securities (old securities) of a particular kind are issued by way of the original issue of securities of that kind,

(b) on a later occasion securities (new securities) of the same kind are issued,

(c) a sum (the extra return) is payable in respect of each new security, by the person issuing it, to reflect the fact that interest is accruing on the old securities,

(d) the issue price of each new security includes an element (whether or not separately identified) representing payment for the extra return, and

(e) the extra return is equal to the amount of interest payable for the relevant period on each old security.

(2) In such a case, the issue price of each new security shall be deemed for the purposes of paragraphs 1(1)(a),(e) and (h) and 11(2) and (3) above to be its actual issue price less an amount equal to the extra return payable in respect of the security.

(3) For the purposes of this paragraph securities are of the same kind if they are treated as being of the same kind by the practice of a recognised stock exchange or would be so treated if dealt with on such a stock exchange.

(4) For the purposes of this paragraph the relevant period is the period beginning with the day following the relevant day and ending with the day on which the new securities are issued.

(5) For the purposes of this paragraph the relevant day is—

(a) the last day of the last (or only) income period to end in respect of the old securities before the day on which the new securities are issued, or

(b) the day on which the old securities were issued, in a case where no income period ended in respect of them before the day on which the new securities are issued.

12.3.29.11.ICTA 1988 Sch.4 para.13

(1) Every company which issued deep discount securities shall cause to be shown on the certificate of each such security the income element for each income period between the date of issue of the security and the redemption date.

(2) Every company which issues a chargeable security to which paragraph 2(1),(2) or (4) above applies shall cause to be shown on the certificate of each such security the fact that tax is chargeable under paragraph 3 above.

(3) Every public body which issued deep discount securities on or after 1st August 1989 shall cause to be shown on the certificate of each such security the income element for each income period between the date of issue of the security and the redemption date.

12.3.29.12.ICTA 1988 Sch.4 para.16

Stock lending

(1) In a case where—

(a) a security is the subject of a transfer which falls within section 129(3), and

(b) the transfer constitutes a disposal to which (apart from this paragraph) paragraph 4 above would apply,

that paragraph shall not apply to the disposal.

(2) Sub-paragraph (1) above shall not apply unless the disposal is made on or after 14th March 1989.

12.3.29.13.ICTA 1988 Sch.4 para.19

Gilts: special rules

(1) In a case where—

(a) securities have been issued by a public body under a prospectus under which no securities were issued before 14th March 1989,

(b) some of the securities issued under the prospectus are gilt-edged securities which are not would-be deep discount securities, and

(c) some of the securities issued under the prospectus are gilt-edged securities which are not would-be deep discount securities, and

[There appears to be a typographical error in the sources used, which I have not investigated. The provision is interesting because the same approach is used in FA 1996 Sch.13]

(d) there is a time when the aggregate nominal value of the securities falling within paragraph (b) above (at that time) exceeds the aggregate nominal value of the securities falling within paragraph (c) above (at that time),

sub-paragraph (2) below shall apply in relation to any gilt-edged security which has been or is issued under the prospectus at any time (whether before, at or after the time mentioned in paragraph (d) above).

(2) As regards any event occurring in relation to the security after the time mentioned in sub-paragraph (1)(d) above, paragraphs 4, 7, 8, 11A, 12 and 14 to 18 above shall have effect as if—

(a) the security were a deep discount security,

(b) it had been issued as such (whatever the time it was issued), and

(c) it had been acquired as such (whatever the time it was acquired).

(3) For the purposes of sub-paragraph (1) above a would-be deep discount security is a security which would be a deep discount security apart from paragraph 1(6) above.

(4) For the purposes of sub-paragraph (2) above events, in relation to a security, include anything constituting a disposal for the purposes of the 1992 Act, the death of a person competent to dispose of the security, a disposal mentioned in paragraph 18(3) above, and an acquisition mentioned in paragraph 18(4) above.

12.3.29.14.ICTA 1988 Sch.4 para.20

Non-gilts: special rules

(1) In a case where—

(a) all the securities issued by a public body on the occasion of the original issue under a particular prospectus (whatever the time of the issue) are neither gilt-edged securities nor deep discount securities,

(b) some of the securities issued under the prospectus are not gilt-edged securities but are new would-be deep discount securities, and

(c) there is a time when the aggregate nominal value of the securities falling within paragraph (b) above (at that time) exceeds the aggregate nominal value of the securities which (looking at the state of affairs at that time) have been issued under the prospectus and are neither gilt-edged securities nor new would-be deep discount securities,

sub-paragraph (2) below shall apply in relation to any security which is not a gilt-edged security but which has been or is issued under the prospectus at any time (whether before, at or after the time mentioned in paragraph (c) above).

(2) As regards any event occurring in relation to the security after the time mentioned in sub-paragraph (1)(c) above, paragraphs 4, 7, 8, 11A, 12 and 14 to 18 above shall have effect as if—

(a) the security were a deep discount security,

(b) it had been issued as such (whatever the time is was issued), and

(c) it had been acquired as such (whatever the time it was acquired).

(3) For the purposes of sub-paragraph (1) above a new would-be deep discount security is a security which—

(a) would be a deep discount security apart from paragraph 1(7) above, and

(b) was issued on or after 14th March 1989.

(4) For the purposes of sub-paragraph (2) above events, in relation to a security, include anything constituting a disposal for the purposes of the 1992 Act, the death of a person competent to dispose of the security, a disposal mentioned in paragraph 18(3) above, and an acquisition mentioned in paragraph 18(4) above.

*12.3.29.15.**ICTA 1988 Sch.4 para.**21*

Convertible securities: special rules

In a case where—

(a) a security is a qualifying convertible security, for the purposes of Schedule 10 to the Finance Act 1990 at the time of its issue, and

(b) apart from this paragraph it would be a deep discount security at that time,

the security shall be treated, at the time of its issue and at all subsequent times, as not being a deep discount security.

12.4. Finance Act 1989

12.4.1.FA 1989 SCHEDULE 11

Deep gain securities

12.4.1.1.FA 1989 Sch.11 para.1

Deep gain securities

(1) For the purposes of this Schedule a deep gain security is a redeemable security (whenever issued) which fulfils the first and second conditions.

(2) The first condition is that, taking the security at the time it is issued and assuming redemption, the amount payable on redemption might constitute a deep gain; and if the security is capable of redemption on one of a number of occasions, this condition is fulfilled if it is fulfilled as regards any one of them.

(3) For the purposes of sub–paragraph (2) above “redemption” does not include any redemption which may be made before maturity only at the option of the person who issued the security (and no other person).

(3A) In the case of a security issued before 13th November 1991, for the purposes of sub–paragraph (2) above “redemption” does not include any redemption which may be made before maturity otherwise than in pursuance of the exercise by the person who holds the security for the time being of an option exercisable only on the effluxion of time or the happening of an event which (judged at the time of the security’s issue) is certain or likely to occur.

(3B) In the case of a security issued on or after 13th November 1991, for the purposes of sub–paragraph (2) above "redemption" does not include any redemption which may be made before maturity otherwise than at the option of the person who holds the security for the time being and as regards which the following conditions are fulfilled (judged at the time of the security's issue)—

(a) the event occasioning redemption is such that, if it occurred and there was no provision for redemption, the interests of the person holding the security at the time of the occurrence might be adversely affected,

(b) the event occasioning redemption is neither certain nor likely to occur,

(c) the event occasioning redemption is not one of a number of events occasioning or allowing redemption before maturity at least one of which is certain or likely to occur, and

(d) the obtaining of a tax advantage by any person is not the main benefit, or one of the main benefits, that might be expected to accrue from the provision for redemption.

(3C) The condition set out in sub–paragraph (3B)(a) above is fulfilled if it is fulfilled by reference to any one potential holder, whether or not it is fulfilled by reference to other potential holders.

(3D) In a case where—

(a) the security is one which under the terms of issue can be converted into or exchanged for a security of a different kind, and

(b) it falls to be decided whether the condition set out in paragraph (b) or (c) of sub–paragraph (3B) above is fulfilled,

the condition concerned shall not be treated as fulfilled unless it is fulfilled having regard only to circumstances in which (judged at the time of the security's issue) the right to convert or exchange cannot be or is unlikely to be exercised.

(3E) In the case of a security issued on or after 13th November 1991, for the purposes of sub–paragraph (2) above "redemption" does not include any redemption which may be made before maturity at the option of the person who holds the security for the time being and as regards which the following conditions are fulfilled (judged at the time of the security's issue)—

(a) the event allowing the option to be exercised is such that, if it occurred and there was no provision for redemption, the interests of the person holding the security at the time of the occurrence might be adversely affected,

(b) the event allowing the option to be exercised is neither certain nor likely to occur,

(c) the event allowing the option to be exercised is not one of a number of events occasioning or allowing redemption before maturity at least one of which is certain or likely to occur, and

(d) the obtaining of a tax advantage by any person is not the main benefit, or one of the main benefits, that might be expected to accrue from the provision for redemption.(3F) The condition set out in sub–paragraph (3E)(a) above is fulfilled if it is fulfilled by reference to any one potential holder, whether or not it is fulfilled by reference to other potential holders.(3G) In a case where—

(a) the security is one which under the terms of issue can be converted into or exchanged for a security of a different kind, and

(b) it falls to be decided whether the condition set out in paragraph (b) or (c) of sub–paragraph (3E) above is fulfilled,

the condition concerned shall not be treated as fulfilled unless it is fulfilled having regard only to circumstances in which (judged at the time of the security's issue) the right to convert or exchange cannot be or is unlikely to be exercised.

(4) The second condition is that the security—

(a) is not a deep discount security (either because the amount payable on redemption is not known at issue or for some other reason),

(b) is not a share in a company,

(c) is not a qualifying indexed security,

(d) is not a convertible security, and

(e) does not fall within sub–paragraph (5),(6) or (7) below.

(5) A security falls within this sub–paragraph if it is a gilt–edged security and—

(a) it was issued before 14th March 1989, or

(b) it was issued on or after that date but was issued under the same prospectus as any gilt–edged security issued before that date.

(6) A security falls within this sub–paragraph if it is a gilt–edged security and—

(a) it was issued under a prospectus under which no securities were issued before 14th March 1989,

(b) it was issued otherwise than on the occasion of the original issue under the prospectus, and

(c) all the securities issued on the occasion of the original issue under the prospectus are gilt–edged securities which are not deep gain securities.

(7) A security falls within this sub–paragraph if it is not a gilt–edged security and was issued (at whatever time) under the same prospectus as any other security which was issued before the security in question and which is not a deep gain security.

(8) For the purposes of this paragraph—

(a) a deep discount security is a security which is a deep discount security for the purposes of Schedule 4 to the Taxes Act 1988,

(b) "qualifying indexed security" has the meaning given by paragraph 2 below, and

(c) a gilt–edged security is a security which is a gilt–edged security for the purposes of the Taxation of Chargeable Gains Act 1992

(9) For the purposes of this paragraph the amount payable on redemption of a security constitutes a deep gain if the issue price is less than the amount so payable, and the amount by which it is less represents more than—

(a) 15 per cent of the amount so payable, or

(b) half Y per cent of the amount so payable, where Y is the number of complete years between the date of issue and the redemption date.

(10) For the purposes of this paragraph the amount payable on redemption does not include any amount payable by way of interest.

12.4.1.2.FA 1989 Sch.11 para.2

Qualifying indexed securities

(1) For the purposes of paragraph 1 above a qualifying indexed security is a security which fulfils each of the conditions set out below.

(2) The first condition is that—

(a) the security is denominated in sterling and under the terms of issue the amount payable on redemption is determined by reference to the movement of the retail prices index,

(b) the security is denominated in a currency other than sterling and under the terms of issue the amount payable on redemption is determined by reference to any similar general index of prices which is published by the government, or by an agent of the government, of the territory in whose currency the security is denominated, or

(c)the security was quoted in the official list of a recognised stock exchange at the time it was issued and under the terms of issue the amount payable on redemption is determined by reference to the movement of a published index of prices of shares quoted in the official list of a recognised stock exchange.

(3) The second condition is that the terms of issue make no provision for conversion into, or redemption in, a currency other than that in which the security is denominated on issue.

(4) The third condition is that under the terms of issue—

(a) interest is payable on the security,

(b) not more than one year can elapse between the day of issue and the first day on which interest becomes payable, or between any day on which interest becomes payable and the next day on which it becomes payable,

(c) the interest payable is determined by reference to a rate which is not less than a reasonable commercial rate (judged by reference to the date of issue and by reference to securities of a similar nature to the one in question), and

(d) the interest payable is also determined by reference to the movement of the index by reference to which the amount payable on redemption is determined.

(5) The fourth condition is that where that index is applied to determine the amount payable on redemption or to determine interest it must, under the terms of issue, be applied precisely and without restriction.

(6) The fifth condition is that—

(a) the security is expressed to be issued for a definite period stated on the face of the security, and

(b) the period so stated commences with the day of issue and is five years or more.

(7) The sixth condition is that the terms of issue contain no provision enabling the person who holds the security for the time being to require any of the following before the expiry of a period which commences with the day of issue and which is five years or more—

(a) the security to be repurchased by the person who issued it;

(b) the security to be purchased by a person other than the person who issued it;

(c) the security to be converted into another kind of security;

(d) the security to be redeemed in circumstances other than any of the qualifying circumstances (set out in sub–paragraph (13) below).

(8) The seventh condition is that, where the issue is handled by an agent for the person making the issue or by an underwriter, the terms on which the agent or underwriter offers the security—

(a) contain no provision for the security to be repurchased by the person who issued it, converted into another kind of security, or redeemed, before the expiry of a period which commences with the day of issue and which is five years or more, and

(b) contain no provision enabling the person who holds the security for the time being to require the security to be purchased, by a person other than the person who issued it, before the expiry of a period which commences with the day of issue and which is five years or more.

(8A) If a security was issued before 9th June 1989, was not quoted in the official list of a recognised stock exchange at the time it was issued, but was quoted in such a list on 8th June 1989, for the purposes of sub–paragraph (2)(c) above it shall be deemed to have been quoted in that list at the time it was issued.

(8B) If a security was issued on or after 9th June 1989, and was quoted in the official list of a recognised stock exchange at a time after it was issued but before the end of the qualifying period, for the purposes of sub–paragraph (2)(c) above it shall be deemed to have been quoted in that list at the time it was issued; and the qualifying period is the period of one month beginning with the day on which the security was issued.

(9) For the purposes of sub–paragraph (5) above “redemption” does not include any redemption which may be made before maturity only at the option of the person who issued the security (and no other person).

(10) In a case where the amount payable on redemption, or the amount of interest, is under the terms of issue determined by reference to the movement of the index for a period (a notional period) in place of a later actual period (a process commonly known as lagging) the fourth condition shall be treated as fulfilled if the following rules are fulfilled—

(a) under the terms of issue the notional period must start not more than eight months before the actual period starts and must end not more than eight months before the actual period ends, and

(b) where the index is applied for the notional period it must, under the terms of issue, be applied precisely and without restriction.

(11) In a case where the terms of issue contain provision for the amount payable on redemption to be not less than an amount stated in the terms, the provision shall not prevent the fourth condition being fulfilled if—

(a) the security was issued before 9th June 1989, and

(b) the amount stated does not constitute a deep gain (within the meaning given by paragraph 1(9) above).

(11A) In a case where the terms of issue contain provision for the amount payable on redemption to be not less than a specified percentage of the issue price, the provision shall not prevent the fourth condition being fulfilled if the specified percentage is not greater than 10.

(12) In a case where—

(a) the terms of issue contain provision for the amount payable on redemption in any of the qualifying circumstances (set out in sub–paragraph (13) below) to be not less than an amount stated in the terms, and

(b) the security was issued before 9th June 1989,

the provision shall not prevent the fourth condition being fulfilled.

(12A) In a case where—

(a) the terms of issue contain provision for the amount payable on redemption in any of the qualifying circumstances (set out in sub–paragraph (13) below) to be not more than the issue price, and

(b) the security was issued on or after 9th June 1989,

the provision shall not prevent the fourth condition being fulfilled.(13) For the purposes of sub–paragraphs (7),(12) and (12A)above the following are qualifying circumstances—

(a) there is a fundamental change in the rules governing the index and the change would be detrimental to the interests of the person who holds the security for the time being;

(b) the index ceases to be published without being replaced by a comparable index;

(c) in the case of a security issued before 13th November 1991, any circumstances except circumstances in which the person who holds the security for the time being exercises an option exercisable only on the effluxion of time or the happening of an event which (judged at the time of the security's issue) is certain or likely to occur;

(d) in the case of a security issued on or after 13th November 1991, any circumstances for redemption which may be made before maturity otherwise than at the option of the person who holds the security for the time being and as regards which the conditions set out in paragraph 1(3B) above are fulfilled (judged at the time of the security's issue and read subject to paragraph 1(3C) and (3D) above);

(e) in the case of a security issued on or after 13th November 1991, any circumstances for redemption which may be made before maturity at the option of the person who holds the security for the time being and as regards which the conditions set out in paragraph 1(3E) above are fulfilled (judged at the time of the security's issue and read subject to paragraph 1(3F) and (3G) above).

(14) In a case where an issue is handled by an agent for the person making the issue, or by an underwriter, for the purposes of sub–paragraphs (2) to (5) and (10) above the terms of issue shall be taken to include any terms on which the agent or underwriter offers the security.

(15) For the purposes of this paragraph the amount payable on redemption does not include any amount payable by way of interest.

(16) For the purposes of this paragraph "control" (in relation to a company) shall be construed in accordance with section 840 of the Taxes Act 1988.

12.4.1.3.FA 1989 Sch.11 para.3

Convertible securities

(1) For the purposes of paragraph 1 above a security is a convertible security if—

(a) it was issued by a company before 9th June 1989,

(b) under the terms of issue it can be converted into or exchanged for share capital in a company (whether or not the company is the one which issued the security), and

(c) the condition set out in sub–paragraph (2) below is fulfilled.

(2) The condition is that—

(a) at some time in the qualifying period the security was quoted in the official list of a recognised stock exchange,

(b) at some time in that period relevant share capital was so quoted, or

(c) each of paragraphs (a) and (b) above is satisfied (though not necessarily as regards the same time).

(3) For the purposes of sub–paragraph (2) above the qualifying period is the period of one month beginning with the day on which the security was issued.

(4) For the purposes of sub–paragraph (2) above relevant share capital is share capital in the company into whose share capital the security can be converted or for whose share capital the security can be exchanged; and relevant share capital need not be share capital into or for which the security can be converted or exchanged.

(5) References in this paragraph to share capital are to share capital by whatever name called.

12.4.1.4.FA 1989 Sch.11 para.3A

Issue price

(1) This paragraph applies where—

(a) securities (old securities) of a particular kind are issued by way of the original issue of securities of that kind,

(b) on a later occasion securities (new securities) of the same kind are issued,

(c) a sum (the extra return) is payable in respect of each new security, by the person issuing it, to reflect the fact that interest is accruing on the old securities,

(d) the issue price of each new security includes an element (whether or not separately identified) representing payment for the extra return, and

(e) the extra return is equal to the amount of interest payable for the relevant period on each old security.

(2) In such a case, the issue price of each new security shall be deemed for the purposes of paragraph 1(9) above to be its actual issue price less an amount equal to the extra return payable in respect of the security.

(3) For the purposes of this paragraph securities are of the same kind if they are treated as being of the same kind by the practice of a recognised stock exchange or would be so treated if dealt with on such a stock exchange.

(4) For the purposes of this paragraph the relevant period is the period beginning with the day following the relevant day and ending with the day on which the new securities are issued.

(5) For the purposes of this paragraph the relevant day is—

(a) the last (or only) interest payment day to fall in respect of the old securities before the day on which the new securities are issued, or

(b) the day on which the old securities were issued, in a case where no interest payment day fell in respect of them before the day on which the new securities are issued;

and an interest payment day, in relation to the old securities, is a day on which interest is payable under them.

12.4.1.5.FA 1989 Sch.11 para.4

Meaning of transfer etc

(1) This paragraph has effect for the purposes of this Schedule.

(2) “Transfer”, in relation to a security, means transfer by way of sale, exchange, gift or otherwise.

(2A) But (notwithstanding sub–paragraph (2) above) “transfer” does not include a transfer made on a conversion of a security into share capital in a company.(3) Where an agreement for the transfer of a security is made, it is transferred, and the person to whom it is agreed to be transferred becomes entitled to it, when the agreement is made and not on a later transfer made pursuant to the agreement; and “entitled”, “transfer” and cognate expressions shall be construed accordingly.

(4) A person holds a security at a particular time if he is entitled to it at the time.

(5) A person acquires a security when he becomes entitled to it; and “acquisition” shall be construed accordingly.

(6) If an agreement is conditional (whether on the exercise of an option or otherwise) for the purposes of sub–paragraph (3) above it is made when the condition is exercised.

12.4.1.6.FA 1989 Sch.11 para.5

Charge to tax on transfer

(1) This paragraph applies if—

(a) there is a transfer of a deep gain security on or after 14th March 1989 (irrespective of when the person making the transfer acquired it), and

(b) the amount obtained on transfer exceeds the amount paid on acquisition.

(2) In such a case—

(a) an amount equal to the difference between those two amounts, less the amount of any costs, shall be treated as income of the person making the transfer,

(b) the income shall be chargeable to tax under Case III or Case IV (as the case may be) of Schedule D,

(c) the income shall be treated as arising in the year of assessment in which the transfer takes place, and

(d) notwithstanding anything in sections 64 to 67 of the Taxes Act 1988, the tax shall be computed on the income arising in the year of assessment for which the computation is made.

(3) For the purposes of this paragraph—

(a) the amount obtained on transfer is the amount obtained, in respect of the transfer, by the person making it,

(b) the amount paid on acquisition is the amount paid by that person in respect of his acquisition of the security (or his last acquisition of it before the transfer), and

(c) costs are the costs incurred by that person in connection with the transfer and with his acquisition of the security (or his last acquisition of it before the transfer).

(4) For the purposes of sub–paragraph (3)(a) above the person making the transfer shall be treated as obtaining in respect of it—

(a) any amount he actually obtains in respect of it, and

(b) any amount he is entitled to obtain, but does not obtain, in respect of it.

(5) Sub–paragraph (4) above shall not apply where paragraph 7, 8 or 9 below applies.

12.4.1.7.FA 1989 Sch.11 para.6

Redemption

(1) Paragraph 5 above applies where there is a redemption of a deep gain security as well as where there is a transfer.

(2) In its application by virtue of sub–paragraph (1) above, paragraph 5 above shall have effect as if—

(a) references to the person making the transfer were to the person who was entitled to the security immediately before redemption, and

(b) other references to transfer were to redemption.

12.4.1.8.FA 1989 Sch.11 para.7

Death

(1) Where an individual who is entitled to a security dies, for the purposes of this Schedule—

(a) he shall be treated as transferring it to his personal representatives immediately before his death, and

(b) he shall be treated as obtaining in respect of the transfer an amount equal to the market value of the security at the time of the transfer.

(2) Where a security is transferred by personal representatives to a legatee, for the purposes of paragraph 5 above they shall be treated as obtaining in respect of the transfer an amount equal to the market value of the security at the time of the transfer.

(3) In sub–paragraph (2) above “legatee” includes any person taking (whether beneficially or as trustee) under a testamentary disposition or on an intestacy or partial intestacy, including any person taking by virtue of an appropriation by the personal representatives in or towards satisfaction of a legacy or other interest or share in the deceased’s property.

12.4.1.9.FA 1989 Sch.11 para.8

Connected persons

(1) This paragraph applies where a security is transferred from one person to another (whether or not on or after 14th March 1989) and they are connected with each other.

(2) For the purposes of paragraph 5 above—

(a) the person making the transfer shall be treated as obtaining in respect of it an amount equal to the market value of the security at the time of the transfer, and

(b) the person to whom the transfer is made shall be treated as paying in respect of his acquisition of the security an amount equal to that market value.

(3) Section 839 of the Taxes Act 1988 (connected persons) shall apply for the purposes of this paragraph.

12.4.1.10.FA 1989 Sch.11 para.9

Market value

(1) This paragraph applies where a security is transferred from one person to another (whether or not on or after 14th March 1989) and—

(a) the transfer is made for a consideration which consists of or includes consideration not in money or money's worth, or

(b) the transfer is made otherwise than by way of a bargain made at arm's length.

(2) For the purposes of paragraph 5 above—

(a) the person making the transfer shall be treated as obtaining in respect of it an amount equal to the market value of the security at the time of the transfer, and

(b) the person to whom the transfer is made shall be treated as paying in respect of his acquisition of the security an amount equal to that market value.

12.4.1.11.FA 1989 Sch.11 para.16

Stock lending

In a case where—

(a) a security is the subject of a transfer which falls within section 129(3) of the Taxes Act 1988, and

(b) paragraph 5 above would apply to the transfer (apart from this paragraph),

that paragraph shall not apply to the transfer.

12.4.1.12.FA 1989 Sch.11 para.17

Accrued income scheme

In a case where—

(a) a security is the subject of a transfer to which paragraph 5 above applies, and

(b) apart from this paragraph, the transfer would be a transfer for the purposes of sections 710 to 728 of the Taxes Act 1988,

the transfer shall not be a transfer for those purposes.

12.4.1.13.FA 1989 Sch.11 para.19A

Early redemption: special rules

(1) Sub–paragraph (2) below applies where—

(a) a security is issued on or after 13th November 1991,

(b) it would be a deep gain security apart from paragraph 1(3B) or (3E) above,

(c) it is redeemed before maturity, and

(d) immediately before redemption it was held by a person connected with the person who issued it.

(2) As regards the redemption, paragraphs 5 to 19 above shall have effect as if—

(a) the security were a deep gain security, and

(b) it had been acquired as such (whatever the time it was acquired).

(3) Sub–paragraph (4) below applies where—

(a) the conditions set out in sub–paragraph (1)(a) to (c) above are fulfilled,

(b) the security was transferred in the period ending with redemption and beginning with the day falling one year before the day of redemption, and

(c) the transfer was by a person connected with the person who issued the security.

(4) As regards the transfer, paragraphs 5 to 19 above shall have effect as if—

(a) the security were a deep gain security, and

(b) it had been acquired as such (whatever the time it was acquired).

(5) Section 839 of the Taxes Act 1988 (connected persons) shall apply for the purposes of this paragraph.

12.4.1.14.FA 1989 Sch.11 para.20

Gilts: special rules

(1) In a case where—

(a) securities have been issued under a prospectus under which no securities were issued before 14th March 1989,

(b) some of the securities issued under the prospectus are gilt–edged securities which are would–be deep gain securities,

(c) some of the securities issued under the prospectus are gilt–edged securities which are not would–be deep gain securities, and

(d) there is a time when the aggregate nominal value of the securities falling within paragraph (b) above (at that time) exceeds the aggregate nominal value of the securities falling within paragraph (c) above (at that time),

sub–paragraph (2) below shall apply in relation to any gilt–edged security which has been or is issued under the prospectus at any time (whether before, at or after the time mentioned in paragraph (d) above).

(2) As regards any event occurring in relation to the security after the time mentioned in sub–paragraph (1)(d) above, paragraphs 5 to 19 above shall have effect as if—

(a) the security were a deep gain security, and

(b) it had been acquired as such (whatever the time it was acquired).

(3) For the purposes of sub–paragraph (1) above a would–be deep gain security is a security which would be a deep gain security apart from paragraph 1(6) above.

(4) In sub–paragraph (1) above “gilt–edged security” has the same meaning as in paragraph 1 above.

(5) For the purposes of sub–paragraph (2) above events, in relation to a security, include anything constituting a transfer or acquisition for the purposes of this Schedule.

12.4.1.15.FA 1989 Sch.11 para.21

Non–gilts: special rules

(1) In a case where—

(a) all the securities issued on the occasion of the original issue under a particular prospectus (whatever the time of the issue) are neither gilt–edged securities nor deep gain securities,

(b) some of the securities issued under the prospectus are not gilt–edged securities but are new would–be deep gain securities, and

(c) there is a time when the aggregate nominal value of the securities falling within paragraph (b) above (at that time) exceeds the aggregate nominal value of the securities which (looking at the state of affairs at that time) have been issued under the prospectus and are neither gilt–edged securities nor new would–be deep gain securities,

sub–paragraph (2) below shall apply in relation to any security which is not a gilt–edged security but which has been or is issued under the prospectus at any time (whether before, at or after the time mentioned in paragraph (c) above).

(2) As regards any event occurring in relation to the security after the time mentioned in sub–paragraph (1)(c) above, paragraphs 5 to 19 above shall have effect as if—

(a) the security were a deep gain security, and

(b) it had been acquired as such (whatever the time it was acquired).

(3) For the purposes of sub–paragraph (1) above , and subject to paragraph 21A below,a new would–be deep gain security is a security which—

(a) would be a deep gain security apart from paragraph 1(7) above, and

(b) was issued on or after 14th March 1989.

(4) In sub–paragraph (1) above “gilt–edged security” has the same meaning as in paragraph 1 above.

(5) For the purposes of sub–paragraph (2) above events, in relation to a security, include anything constituting a transfer or acquisition for the purposes of this Schedule.

12.4.2.FA 1993 S.61

Qualifying debts for purposes of sections 63 to 66

(1) A debt is a qualifying debt for the purposes of sections 63 to 66 below at any time if, at that time—

(a) the person entitled to the debt is a company which is resident in the United Kingdom ("the resident company");

(b) the person liable for the debt is either a qualifying company or a qualifying third party; and

(c) the debt is not an exempted debt for those purposes.

(2) A company is a qualifying company for the purposes of this section and section 62 below at any time if, at that time, the company—

(a) is an associated company of the resident company, and

(b) is resident outside the United Kingdom.

(3) …

(4) A third party, that is to say, a person who is not an associated company of the resident company, is a qualifying third party for the purposes of this section and section 62 below at any time if, at that time, each of the two conditions mentioned below is fulfilled.

(5) The first condition is that, in pursuance of any arrangements made with the third party, that party has at any earlier time been put in funds (directly or indirectly)—

(a) by the resident company or by a company which was at that earlier time an associated company of the resident company, or

(b) by a person from whom the resident company has (directly or indirectly) acquired the debt or by a company which was at that earlier time an associated company of that person.

(6) The second condition is that, in pursuance of those arrangements, a company which is a qualifying company has at any earlier time been put in funds (directly or indirectly) by the third party or by a company which was at that earlier time an associated company of that party.

(7) In this section—

"associated company" shall be construed in accordance with section 416 of the Taxes Act 1988;

"double taxation arrangements" means double taxation arrangements having effect by virtue of section 788 of that Act.

12.4.3.FA 1993 S.62

Exempted debts for those purposes

(1) A debt is an exempted debt for the purposes of sections 63 to 66 below at any time if each of the first, second and third conditions mentioned below—

(a) is fulfilled at that time;

(b) has been fulfilled throughout so much of the period of the debt as falls before that time; and

(c) is likely to be fulfilled throughout so much of that period as falls after that time.

(2) The first condition is that the terms of the debt provide that any interest carried by it shall be at a rate which falls into one, and one only, of the following categories—

(a) a fixed rate which is the same throughout the period of the debt;

(b) a rate which bears to a standard published rate the same fixed relationship throughout that period; and

(c) a rate which bears to a published index of prices the same fixed relationship throughout that period.

(3) The second condition is that those terms provide for any such interest to be payable as it accrues at intervals of 12 months or less.

(4) The third condition is that those terms are such that—

(a) the amount payable on the debt's redemption cannot exceed the amount of the consideration given for it, or

(b) the debt must be redeemed within 12 months of its creation.

(5) For the purposes of subsection (4) above the amount payable on a debt's redemption does not include any amount payable by way of interest.

(6) A debt is an exempted debt for the purposes of sections 63 to 66 below at any time if the inspector is satisfied that the fourth condition mentioned below is fulfilled and either—

(a) he is also so satisfied with respect to the fifth condition so mentioned, or

(b) the sixth condition so mentioned is fulfilled.

(7) The fourth condition is that the possibility of returns on the debt being chargeable to tax as they arise rather than as they accrue was not the main reason, or one of the main reasons, why the resident company created the debt on the qualifying terms, acquired the debt on those terms or (as the case may be) agreed to the subsequent inclusion of those terms.

(8) The fifth condition is that, even if the person liable for the debt were none of the following, namely—

(a) a qualifying company;

(b) a qualifying third party; and

(c) a person who would be such a company or party if paragraph (b) of section 61(2) above were omitted,

the resident company would have still created the debt on the qualifying terms, acquired the debt on those terms or (as the case may be) agreed to the subsequent inclusion of those terms.

(9) Where it is not the resident company's business to make loans generally, that fact shall be disregarded in applying subsection (8) above.

(10) The sixth condition is that the terms of the debt—

(a) are such that the debt must be redeemed before the end of the relevant period, or

(b) provide for any interest accruing during that period to be payable no later than immediately after the end of that period and for any interest subsequently accruing to be payable as it accrues at intervals of 12 months or less.

(11) In subsection (10) above "the relevant period" means the period of 24 months beginning with the date when the resident company created the debt on the qualifying terms, acquired the debt on those terms or (as the case may be) agreed to the subsequent inclusion of those terms.

(12) A debt is an exempted debt for the purposes of sections 63 to 66 below at any time if the inspector is satisfied that, at that time, the seventh condition mentioned below was fulfilled.

(13) The seventh condition is that, by reason of its inability to pay its debts, the principal debtor—

(a) has been, is in the course of being or is likely to be wound up, or

(b) has been or is likely to be dissolved,

under or by virtue of the laws of the territory in which it is or was incorporated.

(14) Any reference in subsection (13) above to the principal debtor having been or being likely to be dissolved includes a reference to its otherwise having ceased or being likely to cease to exist as a company.

(15) Where there is an appeal arising under subsection (6) or (12) above, that subsection shall be construed as if the reference to the inspector being satisfied were a reference to the Commissioners concerned being satisfied.

(16) In this section—

"the principal debtor" means the qualifying company liable for the debt or, as the case may be, the qualifying company mentioned in section 61(6) above;

"published index of prices" means the retail prices index or any similar general index of prices which is published by, or by an agent of, the government of any territory outside the United Kingdom;

"qualifying terms", in relation to a debt, means such of the terms of the debt as preclude it from being an exempted debt by virtue of subsection (1) above.

12.4.4. FA 1993 S.62A

Application of sections 63 to 66: supplementary

In sections 63 to 66 below as they apply by virtue of section 61 above—

(a) “the creditor company” means the company identified in subsection (1) of that section as the person entitled to the debt (referred to there as “the resident company”); and

(b) “the commencement date” means 1st April 1993.

12.4.5.FA 1993 S.63

Accrued income securities

(1) Subsection (2) below applies where the debt on an accrued income security—

(a) is a qualifying debt at the end of the day immediately preceding the commencement date;

(b) becomes such a debt on any day after that date;

(c) ceases to be such a debt on any such day; or

(d) is such a debt at the end of the last day of any accounting period of the creditor companyending after that date;

and in that subsection “the relevant day” means the day mentioned in whichever of paragraphs (a) to (d) above is applicable.

(2) For the purposes of sections 710 to 728 of the Taxes Act 1988 (accrued income scheme) the security—

(a) except in a case falling within paragraph (b) of subsection (1) above, shall be treated as transferred by the creditor companywith accrued interest on the relevant day;

(b) in a case falling within that paragraph where the creditor companywas the holder of the security on the day immediately preceding the relevant day, shall be treated as transferred by that company with accrued interest on that preceding day; and

(c) in a case falling within paragraph (c) of that subsection where the security is not a variable interest rate security, shall cease to be treated as such a security as from the end of the relevant day;

and, in relation to such a transfer, the settlement day is the day of the transfer (notwithstanding section 712).

(3) Subsection (4) below applies where the debt on an accrued income security—

(a) is a qualifying debt at the beginning of the commencement date;

(b) becomes such a debt on any day after that date;

(c) ceases to be such a debt on any such day; or

(d) is such a debt at the beginning of the first day of any accounting period of the creditor companybeginning after that date;

and in that subsection “the relevant day” means the day mentioned in whichever of paragraphs (a) to (d) above is applicable.

(4) For the purposes of sections 710 to 728 the security—

(a) except in a case falling within paragraph (c) of subsection (3) above, shall be treated as transferred to the creditor companywith accrued interest on the relevant day;

(b) in a case falling within that paragraph where the creditor companyis the holder of the security on the day immediately following the relevant day, shall be treated as transferred to that company with accrued interest on that following day; and

(c) in a case falling within paragraph (a) or (b) of that subsection where the security is not a variable interest rate security, shall be treated as such a security as from the beginning of the relevant day;

and, in relation to such a transfer, the settlement day is the day of the transfer (notwithstanding section 712).

(5) Any income which, apart from this subsection, would be treated as arising on any day by virtue of subsection (1)(a) or (b) above shall be treated as not arising until whichever of the following is the earliest, namely—

(a) the earliest day on which, under the terms on which the security is issued,the creditor companyis entitled to require it to be redeemed;

(b) the day on which the security is redeemed; and

(c) the day (if any) on which it is transferred by the creditor company

(6) Subsection (7) below applies where, in the case of a debt which is not a debt on a security, the terms of the debt are such that, if it were such a debt, the security would be an accrued income security.

(7) For the purposes of this section and sections 710 to 728, at any time when the debt is a qualifying debt—

(a) an accrued income security incorporating the terms of the debt shall be deemed to be held by the creditor company and

(b) the debt shall be deemed to be a debt on that security.

(8) Subsections (9) and (10) below shall apply where an accrued income security (including one deemed to be held by virtue of subsection (7) above) is treated by virtue of subsection (1)(c) or (d) above as transferred on any day by the creditor company

(9) In subsection (10) below “straddling period” means a period which would (by virtue of section 711(3) and (4) and apart from subsection (10) below) be in relation to the security an interest period beginning on or before and ending after the day of the transfer.

(10) For the purposes of sections 710 to 728 a straddling period is not an interest period but—

(a) the period beginning with the day on which the straddling period begins and ending with the day of the transfer is an interest period; and

(b) the period beginning the day immediately following the day of the transfer and ending with the day on which the straddling period ends is an interest period.

(11) In this section—

“accrued income security” has the same meaning as “security” has for the purposes of sections 710 to 728;

“variable interest rate security” means a security to which section 717 (variable interest rate) applies;

and other expressions to which meanings are assigned for the purposes of those sections have the same meanings as in sections 710 to 728.

12.4.6.FA 1993 S.64

Deep discount securities

(1) Subsection (2) below applies where the debt on a deep discount security—

(a) is a qualifying debt at the end of the day immediately preceding the commencement date;

(b) becomes such a debt at any time after that date;

(c) ceases to be such a debt at any such time; or

(d) is such a debt at the end of the last day of any accounting period of the creditor companyending after that date;

and in that subsection “the relevant time” means the time mentioned in whichever of paragraphs (a) to (d) above is applicable.

(2) For the purposes of Schedule 4 to the Taxes Act 1988 (deep discount securities)the creditor companyshall be deemed—

(a) except in a case falling within paragraph (b) of subsection (1) above, to dispose of the security at the relevant time; and

(b) in a case falling within that paragraph where that company was the holder of the security at a time immediately preceding the relevant time, to dispose of the security at that preceding time.

(3) Subsection (4) below applies where the debt on a deep discount security—

(a) is a qualifying debt at the beginning of the commencement date;

(b) becomes such a debt at any time after that date;

(c) ceases to be such a debt at any such time; or

(d) is such a debt at the beginning of the first day of any accounting period of the creditor companybeginning after that date;

and in that subsection “the relevant time” means the time mentioned in whichever of paragraphs (a) to (d) above is applicable.

(4) For the purposes of Schedule 4 the creditor companyshall be deemed—

(a) except in a case falling within paragraph (c) of subsection (3) above, to acquire the security at the relevant time; and

(b) in a case falling within that paragraph where that company is the holder of the security at a time immediately following the relevant time, to acquire the security at that following time.

(5) Any income which, apart from this subsection, would be treated as arising at any time by virtue of subsection (1)(a) or (b) above shall be treated as not arising until whichever of the following is the earliest, namely—

(a) the earliest time at which, under the terms on which the security is issued,the creditor companyis entitled to require it to be redeemed;

(b) the time at which the security is redeemed; and

(c) the time (if any) at which it is transferred by the creditor company

(6) Subsection (7) below applies where, in the case of a debt which is not a debt on a security, the terms of the debt are such that, if it were such a debt, the security would be a deep discount security.

(7) For the purposes of this section and Schedule 4, at any time when the debt is a qualifying debt—

(a) a deep discount security incorporating the terms of the debt shall be deemed to be held by the creditor company and

(b) the debt shall be deemed to be a debt on that security.

(8) In this section expressions to which meanings are assigned for the purposes of Schedule 4 have the same meanings as in that Schedule.

12.4.7.FA 1993 S.65

Deep gain securities

(1) Subsection (2) below applies where the debt on a deep gain security—

(a) is a qualifying debt at the end of the day immediately preceding the commencement date;

(b) becomes such a debt on any day after that date;

(c) ceases to be such a debt on any such day; or

(d) is such a debt at the end of the last day of any accounting period of the creditor companyending after that date;

and in that subsection “the relevant day” means the day mentioned in whichever of paragraphs (a) to (d) above is applicable.

(2) For the purposes of Schedule 11 to the Finance Act 1989 (deep gain securities)the creditor companyshall be treated—

(a) except in a case falling within paragraph (b) of subsection (1) above, as transferring the security on the relevant day;

(b) in a case falling within that paragraph where the creditor companywas the holder of the security on the day immediately preceding the relevant day, as transferring the security on that preceding day; and

(c)(in either case) as obtaining in respect of the transfer an amount equal to the market value of the security at the time of the transfer.

(3) Subsection (4) below applies where the debt on a deep gain security—

(a) is a qualifying debt at the beginning of the commencement date;

(b) becomes such a debt on any day after that date;

(c) ceases to be such a debt on any such day; or

(d) is such a debt at the beginning of the first day of any accounting period of the creditor companybeginning after that date;

and in that subsection “the relevant day” means the day mentioned in whichever of paragraphs (a) to (d) above is applicable.

(4) For the purposes of Schedule 11 the creditor companyshall be treated—

(a) except in a case falling within paragraph (c) of subsection (3) above, as acquiring the security on the relevant day;

(b) in a case falling within that paragraph where the creditor companyis the holder of the security on the day immediately following the relevant day, as acquiring the security on that following day; and

(c)(in either case) as paying in respect of the acquisition an amount equal to the market value of the security at the time of the acquisition.

(5) Any income which, apart from this subsection, would be treated as arising on any day by virtue of subsection (1)(a) or (b) above shall be treated as not arising until whichever of the following is the earliest, namely—

(a) the earliest day on which, under the terms on which the security is issued,the creditor companyis entitled to require it to be redeemed;

(b) the day on which the security is redeemed; and

(c) the day (if any) on which it is transferred by the creditor company

(6) Subsection (7) below applies where, in the case of a debt which is not a debt on a security, the terms of the debt are such that, if it were such a debt, the security would be a deep gain security.

(7) For the purposes of this section and Schedule 11, at any time when the debt is a qualifying debt—

(a) a deep gain security incorporating the terms of the debt shall be deemed to be held by the creditor company and

(b) the debt shall be deemed to be a debt on that security.

(8) Any reference in this section to Schedule 11 is a reference to that Schedule as it would have effect if paragraphs 1(4)(c) and 22 (exclusion of qualifying indexed securities and special rules for such securities) were omitted; but no income accruing before the commencement date in respect of the debt on a qualifying indexed security shall be chargeable to tax by virtue of this section.

(9) In this section expressions to which meanings are assigned for the purposes of Schedule 11 have the same meanings as in that Schedule.

12.4.8.FA 1993 S.66

Avoidance of double charging

(1) In any case where—

(a) by virtue of sections 63(2) and 65(2) above, a single security is treated as transferred both for the purposes of sections 710 to 728 of the Taxes Act 1988 and for the purposes of Schedule 11 to the Finance Act 1989; and

(b) the transfer for the purposes of that Schedule is one to which paragraph 5 of that Schedule applies,

the creditor companyshall not be chargeable to tax in respect of any income treated as arising by virtue of the transfer for the purposes of sections 710 to 728.

(2) In any case where, by virtue of sections 63(7) and 65(7) above, the same qualifying debt is deemed to be a debt on two separate securities, those securities shall be treated as a single security for the purposes of subsection (1) above.

(3) In any case where, by virtue of subsection (7) of section 63, 64 or 65 above, a qualifying debt is deemed to be a debt on a security, any income which is chargeable to tax as income treated as arising to the creditor companyby virtue of that section shall not also be chargeable to tax as income actually arising.

12.5. Taxation of Chargeable Gains Act 1992

12.5.1.TCGA 1992 S.8

Company's total profits to include chargeable gains

(1) Subject to the provisions of this section and section 400 of the Taxes Act, the amount to be included in respect of chargeable gains in a company's total profits for any accounting period shall be the total amount of chargeable gains accruing to the company in the accounting period after deducting—

(*a*) any allowable loss es accruing to the company in the period, and

(*b*) so far as they have not been allowed as a deduction from chargeable gains accruing in any previous accounting period, any allowable loss es previously accruing to the company while it has been within the charge to corporation tax.

12.5.2.TCGA 1992 S.115

Exemptions for gilt-edged securities and qualifying corporate bonds etc

(1) A gain which accrues on the disposal by any person of—

(*a*) gilt-edged securities or qualifying corporate bonds, or

(*b*) any option or contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds,

shall not be a chargeable gain.

(2) In subsection (1) above the reference to the disposal of a contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds is a reference to the disposal of the outstanding obligations under such a contract.

(3) Without prejudice to section 143(5), where a person who has entered into any such contract as is referred to in subsection (1)(*b*) above closes out that contract by entering into another contract with obligations which are reciprocal to those of the first-mentioned contract, that transaction shall for the purposes of this section constitute the disposal of an asset, namely, his outstanding obligations under the first-mentioned contract.

12.5.3.TCGA 1992 S.116

Reorganisations, conversions and reconstructions

(1) This section shall have effect in any case where a transaction occurs of such a description that, apart from the provisions of this section—

(*a*) sections 127 to 130 would apply by virtue of any provision of Chapter II of this Part; and

(*b*) either the original shares would consist of or include a qualifying corporate bond and the new holding would not, or the original shares would not and the new holding would consist of or include such a bond;

and in paragraph (*b*) above “the original shares” and “the new holding” have the same meaning as they have for the purposes of sections 127 to 130.

(2) In this section references to a transaction include references to any conversion of securities (whether or not effected by a transaction) within the meaning of section 132 andrelevant transaction” means a reorganisation, conversion of securities or other transaction such as is mentioned in subsection (1) above, and, in addition to its application where the transaction takes place after the coming into force of this section, subsection (10) below applies where the relevant transaction took place before the coming into force of this section so far as may be necessary to enable any gain or loss deferred under paragraph 10 of Schedule 13 to the Finance Act 1984 to be taken into account on a subsequent disposal.

(3) Where the qualifying corporate bond referred to in subsection (1)(*b*) above would constitute the original shares for the purposes of sections 127 to 130, it is in this section referred to as “the old asset” and the shares or securities which would constitute the new holding for those purposes are referred to as “the new asset”.

(4) Where the qualifying corporate bond referred to in subsection (1)(*b*) above would constitute the new holding for the purposes of sections 127 to 130, it is in this section referred to as “the new asset” and the shares or securities which would constitute the original shares for those purposes are referred to as “the old asset”.

(4A) In determining for the purposes of subsections (1) to (4) above, as they apply for the purposes of corporation tax—

(*a*) whether sections 127 to 130 would apply in any case, and

(*b*) what, in a case where they would apply, would constitute the original shares and the new holding,

it shall be assumed that every asset representing a loan relationship of a company is a security within the meaning of section 132.(5) So far as the relevant transaction relates to the old asset and the new asset, sections 127 to 130 shall not apply in relation to it.

(6) In accordance with subsection (5) above, the new asset shall not be treated as having been acquired on any date other than the date of the relevant transaction or, subject to subsections (7) and (8) below, for any consideration other than the market value of the old asset as determined immediately before that transaction.

(7) If, on the relevant transaction, the person concerned receives, or becomes entitled to receive, any sum of money which, in addition to the new asset, is by way of consideration for the old asset, that sum shall be deducted from the consideration referred to in subsection (6) above.

(8) If, on the relevant transaction, the person concerned gives any sum of money which, in addition to the old asset, is by way of consideration for the new asset, that sum shall be added to the consideration referred to in subsection (6) above.

(8A) Where subsection (6) above applies for the purposes of corporation tax in a case where the old asset consists of a qualifying corporate bond, Chapter II of Part IV of the Finance Act 1996 (loan relationships) shall have effect so as to require such debits and credits to be brought into account for the purposes of that Chapter in relation to the relevant

transaction as would have been brought into account if the transaction had been a disposal of the old asset at the market value mentioned in that subsection.(9) In any case where the old asset consists of a qualifying corporate bond, then, so far as it relates to the old asset and the new asset, the relevant transaction shall be treated for the purposes of this Act as a disposal of the old asset and an acquisition of the new asset.

(10) Except in a case falling within subsection (9) above, so far as it relates to the old asset and the new asset, the relevant transaction shall be treated for the purposes of this Act as not involving any disposal of the old asset but—

(*a*) there shall be calculated the chargeable gain or allowable loss that would have accrued if, at the time of the relevant transaction, the old asset had been disposed of for a consideration equal to its market value immediately before that transaction; and

(*b*) subject to subsections (12) to (14) below, the whole or a corresponding part of the chargeable gain or allowable loss mentioned in paragraph (*a*) above shall be deemed to accrue on a subsequent disposal of the whole or part of the new asset (in addition to any gain or loss that actually accrues on that disposal); and

(*c*) on that subsequent disposal, section 115 shall have effect only in relation to any gain or loss that actually accrues and not in relation to any gain or loss which is deemed to accrue by virtue of paragraph (*b*) above.

(11) Subsection (10)(*b*) and (*c*) above shall not apply to any disposal falling within section 58(1), 62(4), 139,140A,171(1) or 172, but a person who has acquired the new asset on a disposal falling within any of those sections (and without there having been a previous disposal not falling within any of those sections or a devolution on death) shall be treated for the purposes of subsection (10)(*b*) and (*c*) above as if the new asset had been acquired by him at the same time and for the same consideration as, having regard to subsections (5) to (8) above, it was acquired by the person making the disposal.

(12) In any case where—

(*a*) on the calculation under subsection (10)(*a*) above, a chargeable gain would have accrued, and

(*b*) the consideration for the old asset includes such a sum of money as is referred to in subsection (7) above,

then, subject to subsection (13) below, the proportion of that chargeable gain which that sum of money bears to the market value of the old asset immediately before the relevant transaction shall be deemed to accrue at the time of that transaction.

(13) If … the sum of money referred to in subsection (12)(*b*) above is small, as compared with the market value of the old asset immediately before the relevant transaction, … subsection (12) above shall not apply.

(14) In a case where subsection (12) above applies, the chargeable gain which, apart from that subsection, would by virtue of subsection (10)(*b*) above be deemed to accrue on a subsequent disposal of the whole or part of the new asset shall be reduced or, as the case may be, extinguished by deducting therefrom the amount of the chargeable gain which, by virtue of subsection (12) above, is deemed to accrue at the time of the relevant transaction.

(15) In any case where—

(*a*) the new asset mentioned in subsections (10) and (11) above is a qualifying corporate bond in respect of which an allowable loss is treated as accruing under section 254(2), and

(*b*) the loss is treated as accruing at a time falling after the relevant transaction but before any actual disposal of the new asset subsequent to the relevant transaction,

then for the purposes of subsections (10) and (11) above a subsequent disposal of the new asset shall be treated as occurring at (and only at) the time the loss is treated as accruing.

(16) This section has effect for the purposes of corporation tax notwithstanding anything in section 80(5) of the Finance Act 1996 (matters to be brought into account in the case of loan relationships only under Chapter II of Part IV of that Act).

12.5.4.TCGA 1992 S.117

Meaning of "qualifying corporate bond"

(A1) For the purposes of corporation tax "qualifying corporate bond" means (subject to section 117A and 117B below) any asset representing a loan relationship of a company; and for purposes other than those of corporation tax references to a qualifying corporate bond shall be construed in accordance with the following provisions of this section.(1) For the purposes of this section, a "corporate bond" is a security, as defined in section 132(3)(*b*)—

(*a*) the debt on which represents and has at all times represented a normal commercial loan; and

(*b*) which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling,

and in paragraph (*a*) above "normal commercial loan" has the meaning which would be given by sub-paragraph (5) of paragraph 1 of Schedule 18 to the Taxes Act if for paragraph (*a*)(i) to (iii) of that sub-paragraph there were substituted the words "corporate bonds (within the meaning of section 117 of the 1992 Act)".

(2) For the purposes of subsection (1)(*b*) above—

(*a*) a security shall not be regarded as expressed in sterling if the amount of sterling falls to be determined by reference to the value at any time of any other currency or asset; and

(*b*) a provision for redemption in a currency other than sterling but at the rate of exchange prevailing at redemption shall be disregarded.

(2AA) For the purposes of this section "corporate bond" also includes any asset which is not included in the definition in subsection (1) above and which is a relevant discounted security for the purposes of Schedule 13 to the Finance Act 1996.

(2A) Where it falls to be decided whether at any time on or after 29th November 1994 a security (whenever issued) is a corporate bond for the purposes of this section, a security which falls within paragraph 2(2)(c) of Schedule 11 to the Finance Act 1989 (quoted indexed securities) shall be treated as not being a corporate bond within the definition in subsection (1) above.

(3) For the purposes of this section "corporate bond" also includes a security which is not included in the definition in subsection (1) above, and which—

(a) is a deep gain security for the purposes of Schedule 11 to the Finance Act 1989 ("the 1989 Act"), or

(b) by virtue of paragraph 21(2) of Schedule 11 to the 1989 Act falls to be treated as a deep gain security as there mentioned, or

(c) by virtue of paragraph 22(2) of that Schedule, falls to be treated as a deep gain security as there mentioned, or

(d) by virtue of paragraph 22A(2) or 22B(3) of that Schedule, falls to be treated as a deep gain security as mentioned in the paragraph concerned.2

(4) For the purposes of this section "corporate bond" also includes a share in a building society—

(*a*) which is a qualifying share,

(*b*) which is expressed in sterling, and

(*c*) in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling.

(5) For the purposes of subsection (4) above, a share in a building society is a qualifying share if—

(*a*) it is a permanent interest bearing share, or

(*b*) it is of a description specified in regulations made by the Treasury for the purposes of this paragraph.

(6) Subsection (2) above applies for the purposes of subsection (4) above as it applies for the purposes of subsection (1)(*b*) above, treating the reference to a security as a reference to a share.

(6A) For the purposes of this section "corporate bond" also includes, except in relation to a person who acquires it on or after a disposal in relation to which section 115 has or has had effect in accordance with section 116(10)(*c*), any debenture issued on or after 16th March 1993 which is not a security (as defined in section 132) but—

(*a*) is issued in circumstances such that it would fall by virtue of section 251(6) to be treated for the purposes of section 251 as such a security; and

(*b*) would be a corporate bond if it were a security as so defined.(6B) An excluded indexed security issued on or after 6th April 1996 is not a corporate bond for the purposes of this section; and an excluded indexed security issued before that date shall be taken to be such a bond for the purposes of this section only if—

(*a*) it would be so taken apart from this subsection; and

(*b*) the question whether it should be so taken arises for the purposes of section 116(10)(6C) In subsection (6B) above "excluded indexed security" has the same meaning as in Schedule 13 to the Finance Act 1996 (relevant discounted securities).(7) Subject to subsections (9) and (10) below, for the purposes of this Act, a corporate bond—

(*a*) is a "qualifying" corporate bond if it is issued after 13th March 1984; and

(*b*) becomes a “qualifying” corporate bond if, having been issued on or before that date, it is acquired by any person after that date and that acquisition is not as a result of a disposal which is excluded for the purposes of this subsection, or which was excluded for the purposes of section 64(4) of the Finance Act 1984.

(8) Where a person disposes of a corporate bond which was issued on or before 13th March 1984 and, before the disposal, the bond had not become a qualifying corporate bond, the disposal is excluded for the purposes of subsection (7) above if, by virtue of any enactment—

(*a*) the disposal is treated for the purposes of this Act as one on which neither a gain nor a loss accrues to the person making the disposal; or

(*b*) the consideration for the disposal is treated for the purposes of this Act as reduced by an amount equal to the held-over gain on that disposal, as defined for the purposes of section 165 or 260.

(8A) A corporate bond falling within subsection (2AA) above is a qualifying corporate bond whatever its date of issue.

(9) Subject to subsection (10) below, for the purposes of this Act—

(a) a corporate bond which falls within subsection (3)(a) above is a qualifying corporate bond, whatever the date of its issue;

(b) a corporate bond which falls within subsection (3)(b) above is a qualifying corporate bond as regards a disposal made after the time mentioned in paragraph 21(1)(c) of Schedule 11 to the 1989 Act, whatever the date of its issue;

(c) a corporate bond which falls within subsection (3)(c) above is a qualifying corporate bond as regards a disposal made after the time the agreement mentioned in paragraph 22(1)(b) of that Schedule is made, whatever the date of its issue;

(d) a corporate bond which falls within subsection (3)(d) above is a qualifying corporate bond as regards a disposal made after the time mentioned in paragraph 22A(1)(c) or 22B(2)(b) of that Schedule (as the case may be);

and subsections (7) and (8) above shall not apply in the case of any such bond.[2]

(10) A security which is issued by a member of a group of companies to another member of the same group is not a qualifying corporate bond for the purposes of this Act except in relation to a disposal by a person who (at the time of the disposal) is not a member of the same group as the company which issued the security; and references in this subsection to a group of companies or to a member of a group shall be construed in accordance with section 170(2) to (14).

(11) For the purposes of this section—

(*a*) where a security is comprised in a letter of allotment or similar instrument and the right to the security thereby conferred remains provisional until accepted, the security shall not be treated as issued until there has been acceptance; and

(*b*) “permanent interest bearing share” has the same meaning as in the Building Societies (Designated Capital Resources)(Permanent Interest Bearing Shares) Order 1991.

(12) The Treasury may by regulations provide that for the definition of the expression “permanent interest bearing share” in subsection (11) above (as it has effect for the time being) there shall be substituted a different definition of that expression, and regulations under this subsection or subsection (5)(*b*) above may contain such supplementary, incidental, consequential or transitional provision as the Treasury thinks fit.

(13) This section shall have effect for the purposes of section 254 with the omission of subsections (4) to (6),(11) and (12).

12.5.5. TCGA 1992 S.117A

Assets that are not qualifying corporate bonds for corporation tax purposes

(1) An asset to which this section applies is not a qualifying corporate bond for the purposes of corporation tax in relation to any disposal of that asset.

(2) This section applies to any asset representing a loan relationship of a company where—

(*a*) subsection (3) or (4) below applies to the asset; and

(*b*) it is held in exempt circumstances.

(3) This subsection applies to an asset if—

(*a*) the settlement currency of the debt to which it relates is a currency other than sterling; and

(*b*) that debt is not a debt on a security.

(4) This subsection applies to an asset if the debt to which it relates is a debt on a security and is in a foreign currency.

(5) For the purposes of subsection (4) above a debt is a debt in a foreign currency if it is—

(*a*) a debt expressed in a currency other than sterling;

(*b*) a debt the amount of which in sterling falls at any time to be determined by reference to the value at that time of a currency other than sterling; or

(*c*) subject to subsection (6) below, a debt as respects which provision is made for its conversion into, or redemption in, a currency other than sterling.

(6) A debt is not a debt in a foreign currency for those purposes by reason only that provision is made for its redemption on payment of an amount in a currency other than sterling equal, at the rate prevailing at the date of redemption, to a specified amount in sterling.

(7) The provisions specified in subsection (8) below, so far as they require a disposal to be treated as a disposal on which neither a gain nor a loss accrues, shall not apply to any disposal of an asset to which this section applies.

(8) The provisions referred to in subsection (7) above are—

(*a*) sections 139, 140A, 171 and 172 of this Act; and

(*b*) section 486(8) of the Taxes Act.

(9) Paragraph 3 of Schedule 17 to the Finance Act 1993 shall have effect for construing the reference in subsection (2)(*b*) above to exempt circumstances as if references to a currency were references to the debt to which the relationship relates.

(10) In this section "security" includes a debenture that is deemed to be a security for the purposes of section 251, by virtue of subsection (6) of that section.

12.5.6. TCGA 1992 S.171

Transfers within a group: general provisions

(1) Notwithstanding any provision in this Act fixing the amount of the consideration deemed to be received on a disposal or given on an acquisition, where a member of a group of companies disposes of an asset to another member of the group, both members shall, except as provided by subsections (2) and (3) below, be treated, so far as relates to corporation tax on chargeable gains, as if the asset acquired by the member to whom the disposal is made were acquired for a consideration of such amount as would secure that on the other's disposal neither a gain nor a loss would accrue to that other; but where it is assumed for any purpose that a member of a group of companies has sold or acquired an asset, it shall be assumed also that it was not a sale to or acquisition from another member of the group.

(2) Subsection (1) above shall not apply where the disposal is—

(*a*) a disposal of a debt due from a member of a group of companies effected by satisfying the debt or part of it; or

(*b*) a disposal of redeemable shares in a company on the occasion of their redemption; or

(*c*) a disposal by or to an investment trust; or

(cc) a disposal by or to a venture capital trust; or(cd) a disposal by or to a qualifying friendly society; or(*d*) a disposal to a dual resident investing company; …

(*e*) …

and the reference in subsection (1) above to a member of a group of companies disposing of an asset shall not apply to anything which under section 122 is to be treated as a disposal of an interest in shares in a company in consideration for a capital distribution (as defined in that section) from that company, whether or not involving a reduction of capital.

(3) Subsection (1) above shall not apply to a transaction treated by virtue of sections 127 and 135 as not involving a disposal by the company first mentioned in that subsection.

(4) For the purposes of subsection (1) above, so far as the consideration for the disposal consists of money or money's worth by way of compensation for any kind of damage or injury to assets, or for the destruction or dissipation of assets or for anything which depreciates or might depreciate an asset, the disposal shall be treated as being to the person who, whether as an insurer or otherwise, ultimately bears the burden of furnishing that consideration.

(5) In subsection (2)(cd) above "qualifying friendly society" means a company which is a qualifying society for the purposes of section 461B of the Taxes Act (incorporated friendly societies entitled to exemption from income tax and corporation tax on certain profits).

12.5.7.TCGA 1992 S.251

General provisions

(1) Where a person incurs a debt to another, whether in sterling or in some other currency, no chargeable gain shall accrue to that (that is the original) creditor or his personal representative or legatee on a disposal of the debt, except in the case of the debt on a security (as defined in section 132).

(2) Subject to the provisions of sections 132 and 135 and subject to subsection (1) above, the satisfaction of a debt or part of it (including a debt on a security as defined in section 132) shall be treated as a disposal of the debt or of that part by the creditor made at the time when the debt or that part is satisfied.

(3) Where property is acquired by a creditor in satisfaction of his debt or part of it, then subject to the provisions of sections 132 and 135 the property shall not be treated as disposed of by the debtor or acquired by the creditor for a consideration greater than its market value at the time of the creditor's acquisition of it; but if under subsection (1) above (and in a case not falling within either section 132 or 135) no chargeable gain is to accrue on a disposal of the debt by the creditor (that is the original creditor), and a chargeable gain accrues to him on a disposal by him of the property, the amount of the chargeable gain shall (where necessary) be reduced so as not to exceed the chargeable gain which would have accrued if he had acquired the property for a consideration equal to the amount of the debt or that part of it.

(4) A loss accruing on the disposal of a debt acquired by the person making the disposal from the original creditor or his personal representative or legatee at a time when the creditor or his personal representative or legatee is a person connected with the person making the disposal, and so acquired either directly or by one or more purchases through persons all of whom are connected with the person making the disposal, shall not be an allowable loss.

(5) Where the original creditor is a trustee and the debt, when created, is settled property, subsections (1) and (4) above shall apply as if for the references to the original creditor's personal representative or legatee there were substituted references to any person becoming absolutely entitled, as against the trustee, to the debt on its ceasing to be settled property, and to that person's personal representative or legatee.

(6) For the purposes of this section a debenture issued by any company on or after 16th March 1993 shall be deemed to be a security (as defined in section 132) if—

(*a*) it is issued on a reorganisation (as defined in section 126(1)) or in pursuance of its allotment on any such reorganisation;

(*b*) it is issued in exchange for shares in or debentures of another company and in a case unaffected by section 137 where one or more of the conditions mentioned in paragraphs (*a*) to (*c*) of section 135(1) is satisfied in relation to the exchange;

(*c*) it is issued under any such arrangements as are mentioned in subsection (1)(*a*) of section 136 and in a case unaffected by section 137 where section 136 requires shares or debentures in another company to be treated as exchanged for, or for anything that includes, that debenture; or

(*d*) it is issued in pursuance of rights attached to any debenture issued on or after 16th March 1993 and falling within paragraph (*a*),(*b*) or (*c*) above.and any debenture which results from a conversion of securities within the meaning of section 132, or is issued in pursuance of rights attached to such a debenture, shall be deemed for the purposes of this section to be a security (as defined in that section).(7) Where any instrument specified in subsection (8) below is not a security (as defined in section 132), that instrument shall be deemed to be such a security for the purposes of this section, other than the purposes of determining what is or is not an allowable loss in any case.(8) The instruments mentioned in subsection (7) above are—

(*a*) any instrument that would fall to be treated for the purposes of this Act as an asset representing a loan relationship of a company if the provisions of sections 92(4) and 93(4) of the Finance Act 1996 (convertible securities and assets linked to the value of chargeable assets) were disregarded; or

(*b*) any instrument which (even apart from those provisions) is not a loan relationship of a company but which would be a relevant discounted security for the purposes of Schedule 13 to that Act if paragraph 3(2)(*c*) of that Schedule (excluded indexed securities) were omitted.

12.6. Finance Act 1993

12.6.1.FA 1993 S.127

Accrual on debts whose amounts vary

(1) In a case where—

(*a*) a qualifying company holds an asset consisting of a right to settlement under a qualifying debt or owes a liability consisting of a duty to settle under such a debt, and

(*b*) the nominal amount of the debt outstanding varies during an accrual period (whether because of an increase or a decrease or both),

the following provisions of this section shall apply for the period and section 125 above shall not.

(1A) For the purposes of this section if, in the case of any debt—

(*a*) an amount in respect of any discount or premium relating to that debt is treated, on an accruals basis of accounting, as accruing at any time for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships), or

(*b*) any such amount would be treated as so accruing if the authorised method of accounting used for those purposes as respects the loan relationship relating to that debt were an accruals basis of accounting, instead of a mark to market basis,

then, for the purposes of this section, there shall be deemed to be such a variation at that time of the nominal amount of the debt outstanding as is specified in subsection (1B) below.

(1B) That variation is—

(*a*) if the amount mentioned in paragraph (*a*) or (*b*) of subsection (1A) above relates to a discount, a variation that increases the nominal amount of the debt outstanding by the amount so mentioned; and

(*b*) if the amount so mentioned relates to a premium, a variation that decreases the nominal amount of the debt outstanding by the amount so mentioned.

(2) In such a case—

(*a*) take the local currency equivalent, at the translation time with which the accrual period begins, of the nominal amount of the debt then outstanding;

(*b*) take the local currency equivalent, at each time (if any) immediately after the nominal amount of the debt outstanding increases in the accrual period, of the amount by which it then increases;

(*c*) take the local currency equivalent, at each time (if any) immediately after the nominal amount of the debt outstanding decreases in the accrual period, of the amount by which it then decreases;

(*d*) take the figure found under paragraph (*a*) above, add each figure found under paragraph (*b*) above, subtract each figure found under paragraph (*c*) above, and call the resulting figure the first amount;

(*e*) take the local currency equivalent, at the translation time with which the accrual period ends, of the nominal amount of the debt then outstanding, and call the figure so found the second amount.

(3) Where the qualifying company has a right to settlement under the debt the following provisions apply in relation to the asset consisting of the right—

(*a*) if the second amount exceeds the first an initial exchange gain of an amount equal to the difference between them accrues to the company as regards the asset for the accrual period;

(*b*) if the second amount is less than the first an initial exchange loss of an amount equal to the difference between them accrues to the company as regards the asset for the accrual period.

(4) Where the qualifying company has a duty to settle under the debt the following provisions apply in relation to the liability consisting of the duty—

(*a*) if the second amount is less than the first an initial exchange gain of an amount equal to the difference between them accrues to the company as regards the liability for the accrual period;

(*b*) if the second amount exceeds the first an initial exchange loss of an amount equal to the difference between them accrues to the company as regards the liability for the accrual period.

(5) If the first amount has a negative value, for the purposes of this section the second amount (however small its value) shall be taken to exceed the first amount (however large its value).

(6) Subsection (7) below modifies the preceding provisions of this section in their application to an asset or liability where there is a difference between—

(*a*) the basic valuation of the asset or liability, and

(*b*) the nominal amount of the debt outstanding at the translation time with which the accrual period begins.

(7) In such a case—

(*a*) the reference in subsection (2)(*a*) above to the nominal amount of the debt outstanding shall be taken to be a reference to the basic valuation of the asset or liability;

(*b*) the reference in subsection (2)(*c*) above to the amount by which the nominal amount of the debt outstanding decreases shall be taken to be a reference to the amount found under subsection (8) below;

(*c*) the reference in subsection (2)(*e*) above to the nominal amount of the debt outstanding shall be taken to be a reference to the amount found under subsection (10) below.

(8) The amount referred to in subsection (7)(*b*) above is the amount given by the formula—

$$A \times \frac{B}{C}$$

(9) For the purposes of subsection (8) above—

A is the basic valuation of the asset or liability;

B is the amount by which, at the time of the decrease mentioned in subsection (2)(*c*) above, the nominal amount of the debt outstanding then decreases;

C is the nominal amount of the debt outstanding at the translation time with which the accrual period begins.

(10) The amount referred to in subsection (7)(*c*) above is the amount given by the formula—

$D + E - F$

(11) For the purposes of subsection (10) above—

D is the basic valuation of the asset or liability;

E is the amount (if any) by which the nominal amount of the debt outstanding has at any time increased in the accrual period or, if it has increased more than once, the aggregate of such amounts;

F is the amount (if any) found under subsection (8) above or, if the nominal amount of the debt outstanding has decreased more than once in the accrual period, the aggregate of the amounts so found.

12.6.2.FA 1993 S.135

Loss disregarded if the main benefit

(1) In a case where—

(*a*) an exchange loss would (apart from this section) accrue to a company for an accrual period,

the loss would accrue as regards an asset or liability falling within section 153(1)(*a*) or (2)(*a*) below,and

the nominal currency of the asset or liability is such that the main benefit or one of the main benefits that might be expected to arise from the company's holding the asset or owing the liability is the accrual of the loss,…

…the loss shall be treated as not accruing.

(2) References in subsection (1) above to an exchange loss are to an exchange loss of a trade or an exchange loss of part of a trade or a non-trading exchange loss.

12.6.3.FA 1993 S.153

Qualifying assets and liabilities

(1) As regards a qualifying company, each of the following is a qualifying asset—

(*a*) a right to settlement under a qualifying debt (whether or not the debt is a debt on a security);

(*b*) a unit of currency;

(*c*) a share held in qualifying circumstances;

but paragraph (*a*) above shall have effect subject to subsections (3) and (4) below.

(2) As regards a qualifying company, each of the following is a qualifying liability—

(*a*) a duty to settle under a qualifying debt (whether or not the debt is a debt on a security);

(*b*) a liability that takes the form of a provision made by the company in respect of a duty to which it may become subject and which (if it were to become subject to it) would be a duty to settle under a qualifying debt;

(*c*) a duty to transfer a right to settlement under a qualifying debt on a security, where the duty subsists under a contract and the company is not entitled to the right;

(*d*) a duty to transfer a share or shares, where the duty subsists under a contract and the company is not entitled to the share or shares;

but paragraphs (*a*) to (*d*) above shall have effect subject to subsections (5) to (9) below.

(3) A right to settlement under a qualifying debt is not a qualifying asset if it is a right under a currency contract.

(4) A right to settlement under a qualifying debt is not a qualifying asset where the company having the right holds an asset representing the debt and that asset is—

(*a*) an asset to which section 92 of the Finance Act 1996 applies (convertible securities); or

(*b*) an asset representing a loan relationship to which section 93 of that Act (relationships linked to the value of chargeable assets) applies.(5) A duty to settle under a qualifying debt is not a qualifying liability if it is a duty under a currency contract.

(6) …

(7) A liability falling within subsection (2)(*b*) above is not a qualifying liability unless—

(*a*) the duty to settle would (if the company were to become subject to it) be owed for the purposes of a trade, and

(*b*) the provision falls to be taken into account (apart from this Chapter) in computing the profits or losses of the trade for corporation tax purposes.

(8) A duty falling within subsection (2)(*c*) above is not a qualifying liability unless the right would be a qualifying asset if the company were entitled to it.

(9) A duty falling within subsection (2)(*d*) above is not a qualifying liability unless the share (or each of the shares) would be a qualifying asset if the company were entitled to it.

(10) For the purposes of this section each of the following is a qualifying debt—

(*a*) a debt falling to be settled by the payment of money;

(*b*) a debt falling to be settled by the transfer of a right to settlement under another debt, itself falling to be settled by the payment of money;

and for the purposes of this subsection an ecu shall be regarded as money.

(11) For the purposes of subsections (1)(*c*) and (4) above qualifying circumstances, in relation to an asset consisting of a share or a right to settlement, are circumstances where the qualifying company carries on a trade and—

(*a*) if the company were to transfer the asset, the transfer would fall to be taken into account (apart from this Chapter) in computing the profits or losses of the trade for corporation tax purposes, and

(*b*) if the asset were held by the company at the end of an accounting period, the valuation of the asset to be shown in the company's accounts for that time would fall to be found by taking the local currency equivalent at that time of the valuation put on the asset by the company (whether at that time or earlier) expressed in the nominal currency of the asset;

and the reference here to the local currency is to the local currency of the trade for the accounting period.

(11A) …

(12) Interest accrued in respect of a debt shall not be treated as part of the debt.

12.7. Finance Act 1994

12.7.1. FA 1994 S.165

Transfers of value by qualifying companies

This section is of limited interest and is not reproduced to save space.

12.7.2. FA 1994 S.166

Transfers of value to associated companies

This section is of limited interest and is not reproduced to save space.

12.7.3. FA 1994 S.167

Transactions not at arm's length

(1) A transaction entered into on or after a qualifying company's commencement day is a relevant transaction for the purposes of this section if as a result of the transaction—

(*a*) the qualifying company becomes party to a qualifying contract, or

(*b*) the terms of a qualifying contract to which the qualifying company is party are varied.

(2) Subsections (3) to (5) below apply where—

(*a*) if the parties to a relevant transaction had been dealing at arm's length, the transaction—

(i) would not have been entered into at all, or

(ii) would have been entered into on different terms,…(b)…but subject, in a case falling within paragraph (*a*)(ii) above, to the modifications made by subsection (7) below.

(3) For each relevant accounting period for the whole of which the other party is a qualifying company, the following deductions shall be made—

(*a*) from amount B, a deduction of such amount as may be necessary to reduce amount B to nil, and

(*b*) from amount A, a deduction of such amount as may be necessary to reduce amount A to nil.

(4) For each relevant accounting period for any part of which the other party is not a qualifying company, the following deductions shall be made—

(*a*) from amount B, a deduction of such amount as may be necessary to reduce amount B to nil, and

(*b*) from amount A, a deduction of the same amount or (where that amount exceeds amount A) a deduction of so much of that amount as may be necessary to reduce amount A to nil.

(5) For each relevant accounting period (except the first) for any part of which the other party is not a qualifying company, there shall also be deducted from amount A or, as the case may require, added to amount B such amount as may be necessary to secure that amount C does not exceed amount D where—

(*a*) amount C is any amount by which the aggregate of adjusted amounts A exceeds the aggregate of adjusted amounts B, and

(*b*) amount D is any amount by which the aggregate of unadjusted amounts A exceeds the aggregate of unadjusted amounts B.

(6) In subsection (5) above—

"adjusted" means adjusted under subsections (4) and (5) above and "unadjusted" shall be construed accordingly;

"the aggregate of adjusted amounts A", in relation to a relevant accounting period, means the aggregate of—

(*a*) adjusted amount A for that period, and

(*b*) adjusted amount A for each preceding relevant accounting period,

and similar expressions shall be construed accordingly.

(7) In a case falling within subsection (2)(*a*)(ii) above—

(*a*) subsections (3) to (5) above shall have effect as if any reference to amount A or amount B were a reference to the relevant proportion of that amount; and

(*b*) the definitions in subsection (6) above of “the aggregate of adjusted amounts A” and similar expressions shall have effect as if any reference to adjusted amount A were a reference to the adjusted relevant proportion of amount A;

and in this subsection “the relevant proportion” means such proportion as may be just and reasonable having regard to the differences between the terms mentioned in subsection (2)(*a*)(ii) above and the terms on which the relevant transaction was actually entered into.

(8) In applying subsections (2) and (7) above—

(*a*) no account shall be taken of any transfer of value in respect of which an adjustment is made under section 165 or 166 above, but

(*b*) subject to that, all factors shall be taken into account.

(9) The factors which may be so taken into account include—

(*a*) in a case where the qualifying contract is an interest rate contract or option, any notional principal amounts and rates of interest that would have been involved;

(*b*) in a case where the qualifying contract is a currency contract or option, any currencies and amounts that would have been involved;

(*ba*) in a case where the qualifying contract is a debt contract or option, the amount of the debt by reference to which any loan relationship that would have been involved would have subsisted, and any terms as to repayment, redemption or interest that, in the case of that debt or any asset representing it, would have been involved;and

(*c*) in any suchcase, any transactions which are related to the relevant transaction.

(10) In this section “relevant accounting period”, in relation to a relevant transaction, means—

(*a*) the accounting period of the qualifying company in which the transaction was entered into, and

(*b*) each subsequent accounting period of that company for the whole or part of which it is party to the contract.

12.7.4.FA 1994 S.168

Qualifying contracts with non-residents

This section is of limited interest and is not reproduced to save space.

12.8. Finance Act 1995

12.8.1.FA 1995 S.50

Corporate bonds

This inserted TCGA 1992 s 117(2A)

12.8.2.FA 1995 S.88

Generalisation of ss 63 to 66 of Finance Act 1993

This section amended FA 1993 ss 63–66 and inserted s 62A

12.8.3.FA 1995 S.89

Application of ss 63 to 66 to debts held by associates of banks

(1) A debt is a qualifying debt for the purposes of sections 63 to 66 of the Finance Act 1993 (deemed periodic disposal of certain debts) at any time if, at that time, the person entitled to the debt is a company which—

(a) is resident in the United Kingdom, and

(b) is an associated company of a company (whether or not itself resident in the United Kingdom) which carries on a banking business in the United Kingdom,

and the debt is not an exempted debt as defined by the following provisions.

(2) A debt is an exempted debt for those purposes at any time if at that time it is held by the company entitled to it for the purposes of long term insurance business.

(3) A debt is an exempted debt for those purposes at any time if each of the first, second and third conditions mentioned below—

(a) is fulfilled at that time,

(b) has been fulfilled throughout so much of the period of the debt as falls before that time, and

(c) is likely to be fulfilled throughout so much of that period as falls after that time.

(4) The first condition is that the terms of the debt provide that any interest carried by it shall be at a rate which falls into one, and one only, of the following categories—

(a) a fixed rate which is the same throughout the period of the debt,

(b) a rate which bears to a standard published rate the same fixed relationship throughout that period, and

(c) a rate which bears to a published index of prices the same fixed relationship throughout that period.

(5) The second condition is that those terms provide for any such interest to be payable as it accrues at intervals of 12 months or less.

(6) The third condition is that the terms of the debt are not such—

(a) in the case of a debt on a security, that the security is a deep discount or deep gain security, or

(b) in any other case, that if the debt were a debt on a security it would be a deep discount or deep gain security.

In this subsection “deep discount security” has the same meaning as in Schedule 4 to the Taxes Act 1988 and “deep gain security” has the same meaning as in Schedule 11 to the Finance Act 1989 disregarding paragraph 1(4)(c) of that Schedule.

(7) In this section—

“associated company” shall be construed in accordance with section 416 of the Taxes Act 1988;

“long term insurance business” means insurance business of any of the classes specified in Schedule 1 to the Insurance Companies Act 1982; and

“published index of prices” means the retail prices index or any similar general index of prices which is published by, or by an agent of, the government of any territory outside the United Kingdom.

(8) In sections 63 to 66 of the Finance Act 1993 as they apply by virtue of this section “the creditor company” means the company identified in subsection (1) above as the person entitled to the debt.

(9) In sections 63 to 66 of the Finance Act 1993 as they apply by virtue of this section “the commencement date” means—

(a) in relation to a debt not falling within subsection (10) below, 29th November 1994; and

(b) in relation to a debt falling within that subsection, 1st April 1996.

(10) A debt falls within this subsection if the person liable for it is—

(a) an institution which is a higher education institution for the purposes of section 65 of the Further and Higher Education Act 1992 or Article 30 of the Education and Libraries (Northern Ireland) Order 1993,

(b) an institution which is an institution within the higher education sector for the purposes of the Further and Higher Education (Scotland) Act 1992 or

(c) a registered housing association within the meaning of the Housing Associations Act 1985 or Part II of the Housing (Northern Ireland) Order 1992,

and that person was so liable at the end of 28th November 1994.

12.9. Finance Act 1996

Chapter II Loan Relationships

12.9.1.FA 1996 S.80

Introductory provisions Taxation of loan relationships.

(1)For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter.

(2) To the extent that a company is a party to a loan relationship for the purposes of a trade carried on by the company, profits and gains arising from the relationship shall be brought into account in computing the profits and gains of the trade.

(3) Profits and gains arising from a loan relationship of a company that are not brought into account under subsection (2) above shall be brought into account as profits and gains chargeable to tax under Case III of Schedule D.

(4) This Chapter shall also have effect for the purposes of corporation tax for determining how any deficit on a company's loan relationships is to be brought into account in any case, including a case where none of the company's loan relationships falls by virtue of this Chapter to be regarded as a source of income.

(5) Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance with this Chapter as respects any matter shall be the only amounts brought into account for the purposes of corporation tax as respects that matter.

12.9.2.FA 1996 S.81

Meaning of "loan relationship" etc.

(1) Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever-

(a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and

(b) that debt is one arising from a transaction for the lending of money;

and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly.

(2) For the purposes of this Chapter a money debt is a debt which falls to be settled-

(a) by the payment of money; or

(b) by the transfer of a right to settlement under a debt which is itself a money debt.

(3) Subject to subsection (4) below, where an instrument is issued by any person for the purpose of representing security for, or the rights of a creditor in respect of, any money debt, then (whatever the circumstances of the issue of the instrument) that debt shall be taken for the purposes of this Chapter to be a debt arising from a transaction for the lending of money.

(4) For the purposes of this Chapter a debt shall not be taken to arise from a transaction for the lending of money to the extent that it is a debt arising from rights conferred by shares in a company.

(5) For the purposes of this Chapter-

(a) references to payments or interest under a loan relationship are references to payments or interest made or payable in pursuance of any of the rights or liabilities under that relationship; and

(b) references to rights or liabilities under a loan relationship are references to any of the rights or liabilities under the agreement or arrangements by virtue of which that relationship subsists;

and those rights or liabilities shall be taken to include the rights or liabilities attached to any security which, being a security issued in relation to the money debt in question, is a security representing that relationship.

(6) In this Chapter "money" includes money expressed in a currency other than sterling.

12.9.3.FA 1996 S.82

Taxation of profits and gains and relief for deficits Method of bringing amounts into account.

(1) For the purposes of corporation tax-

(a) the profits and gains arising from the loan relationships of a company, and

(b) any deficit on a company's loan relationships,

shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter.

(2) To the extent that, in any accounting period, a loan relationship of a company is one to which it is a party for the purposes of a trade carried on by it, the credits and debits given in respect of that relationship for that period shall be treated (according to whether they are credits or debits) either-

(a) as receipts of that trade falling to be brought into account in computing the profits and gains of that trade for that period; or

(b) as expenses of that trade which are deductible in computing those profits and gains.

(3) Where for any accounting period there are, in respect of the loan relationships of a company, both-

(a) credits that are not brought into account under subsection (2) above ("non-trading credits"), and

(b) debits that are not so brought into account ("non-trading debits"),

the aggregate of the non-trading debits shall be subtracted from the aggregate of the non-trading credits to give the amount to be brought into account under subsection (4) below.

(4) That amount is the amount which for any accounting period is to be taken (according to whether the aggregate of the non-trading credits or the aggregate of the non-trading debits is the greater) to be either-

(a) the amount of the company's profits and gains for that period that are chargeable under Case III of Schedule D as profits and gains arising from the company's loan relationships; or

(b) the amount of the company's non-trading deficit for that period on its loan relationships.

(5) Where for any accounting period a company has non-trading credits but no non-trading debits in respect of its loan relationships, the aggregate amount of the credits shall be the amount of the company's profits and gains for that period that are chargeable under Case III of Schedule D as profits and gains arising from those relationships.

(6) Where for any accounting period a company has non-trading debits but no non-trading credits in respect of its loan relationships, that company shall have a non-trading deficit on its loan relationships for that period equal to the aggregate of the debits.

(7) Subsection (2) above, so far as it provides for any amount to be deductible as mentioned in paragraph (b) of that subsection, shall have effect notwithstanding anything in section 74 of the Taxes Act 1988 (allowable deductions).

12.9.4.FA 1996 S.83

Non-trading deficit on loan relationships.

(1) This section applies for the purposes of corporation tax where for any accounting period ("the deficit period") there is a non-trading deficit on a company's loan relationships.

(2) The company may make a claim for the whole or any part of the deficit to be treated in any of the following ways, that is to say-

(a) to be set off against any profits of the company (of whatever description) for the deficit period;

(b) to be treated as eligible for group relief;

(c) to be carried back to be set off against profits for earlier accounting periods; or

(d) to be carried forward and set against non-trading profits for the next accounting period.

(3) So much of the deficit for the deficit period as is not the subject of a claim under subsection (2) above shall be carried forward so as to be brought into account for the purposes of this Chapter as a non-trading debit ("a carried-forward debit") for the accounting period immediately following the deficit period.

(4) No claim shall be made under subsection (2)(a) to (c) above in respect of so much (if any) of the non-trading deficit of a company for any accounting period as is equal to the amount by which that deficit is greater than it would have been if any carried-forward debit for that period had been disregarded.

(5) No part of any non-trading deficit of a company established for charitable purposes only shall be set off against the profits of that or any other company in pursuance of a claim under subsection (2) above.

(6) A claim under subsection (2) above must be made within the period of two years immediately following the end of the relevant period, or within such further period as the Board may allow.

(7) In subsection (6) above "the relevant period"-

(a) in relation to a claim under subsection (2)(a), (b) or (c) above, means the deficit period; and

(b) in relation to a claim under subsection (2)(d) above, means the accounting period immediately following the deficit period.

(8) Different claims may be made under subsection (2) above as respects different parts of a non-trading deficit for any period, but no claim may be made as respects any part of a deficit to which another claim made under that subsection relates.

(9) Schedule 8 to this Act (which makes provision about what happens where a claim is made under subsection (2) above) shall have effect.

12.9.5.FA 1996 S.84

Computational provisions etc. Debits and credits brought into account.

(1) The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, in accordance with an authorised accounting method and when taken together, fairly represent, for the accounting period in question-

(a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions; and

(b) all interest under the company's loan relationship and all charges and expenses incurred by the company under or for the purposes of its loan relationships and related transactions.

(2) The reference in subsection (1) above to the profits, gains and losses arising to a company-

(a) does not include a reference to any amounts required to be transferred to the company's share premium account; but

(b) does include a reference to any profits, gains or losses which, in accordance with normal accountancy practice, are carried to or sustained by any other reserve maintained by the company.

(3) The reference in subsection (1)(b) above to charges and expenses incurred for the purposes of a company's loan relationships and related transactions does not include a reference to any charges or expenses other than those incurred directly-

(a) in bringing any of those relationships into existence;

(b) in entering into or giving effect to any of those transactions;

(c) in making payments under any of those relationships or in pursuance of any of those transactions; or

(d) in taking steps for ensuring the receipt of payments under any of those relationships or in accordance with any of those transactions.

(4) Where-

(a) any charges or expenses are incurred by a company for purposes connected-

(i) with entering into a loan relationship or related transaction, or

(ii) with giving effect to any obligation that might arise under a loan relationship or related transaction,

(b) at the time when the charges or expenses are incurred, the relationship or transaction is one into which the company may enter but has not entered, and

(c) if that relationship or transaction had been entered into by that company, the charges or expenses would be charges or expenses incurred as mentioned in subsection (3) above,

those charges or expenses shall be treated for the purposes of this Chapter as charges or expenses in relation to which debits may be brought into account in accordance with subsection (1)(b) above to the same extent as if the relationship or transaction had been entered into.

(5) In this section "related transaction", in relation to a loan relationship, means any disposal or acquisition (in whole or in part) of rights or liabilities under that relationship.

(6) The cases where there shall be taken for the purposes of this section to be a disposal and acquisition of rights or liabilities under a loan relationship shall include those where such rights or liabilities are transferred or extinguished by any sale, gift, exchange, surrender, redemption or release.

(7) This section has effect subject to Schedule 9 to this Act (which contains provision disallowing certain debits and credits for the purposes of this Chapter and making assumptions about how an authorised accounting method is to be applied in certain cases).

12.9.6.FA 1996 S.85

Authorised accounting methods.

(1) Subject to the following provisions of this Chapter, the alternative accounting methods that are authorised for the purposes of this Chapter are-

(a) an accruals basis of accounting; and

(b) a mark to market basis of accounting under which any loan relationship to which that basis is applied is brought into account in each accounting period at a fair value.

(2) An accounting method applied in any case shall be treated as authorised for the purposes of this Chapter only if-

(a) it conforms (subject to paragraphs (b) and (c) below) to normal accountancy practice, as followed in cases where such practice allows the use of that method;

(b) it contains proper provision for allocating payments under a loan relationship to accounting periods; and

(c) where it is an accruals basis of accounting, it does not contain any provision (other than provision comprised in authorised arrangements for bad debt) that gives debits by reference to the valuation at different times of any asset representing a loan relationship.

(3) In the case of an accruals basis of accounting, proper provision for allocating payments under a loan relationship to accounting periods is provision which-

(a) allocates payments to the period to which they relate, without regard to the periods in which they are made or received or in which they become due and payable;

(b) includes provision which, where payments relate to two or more periods, apportions them on a just and reasonable basis between the different periods;

(c) assumes, subject to authorised arrangements for bad debt, that, so far as any company in the position of a creditor is concerned, every amount payable under the relationship will be paid in full as it becomes due;

(d) secures the making of the adjustments required in the case of the relationship by authorised arrangements for bad debt; and

(e) provides, subject to authorised arrangements for bad debt and for writing off government investments, that, where there is a release of any liability under the relationship, the appropriate amount in respect of the release is credited to the debtor in the accounting period in which the release takes place.

(4) In the case of a mark to market basis of accounting, proper provision for allocating payments under a loan relationship to accounting periods is provision which allocates payments to the accounting period in which they become due and payable.

(5) In this section-

(a) the references to authorised arrangements for bad debt are references to accounting arrangements under which debits and credits are brought into account in conformity with the provisions of paragraph 5 of Schedule 9 to this Act; and

(b) the reference to authorised arrangements for writing off government investments is a reference to accounting arrangements that give effect to paragraph 7 of that Schedule.

(6) In this section "fair value", in relation to any loan relationship of a company, means the amount which, at the time as at which the value falls to be determined, is the amount that the company would obtain from or, as the case may be, would have to pay to an independent person for-

(a) the transfer of all the company's rights under the relationship in respect of amounts which at that time are not yet due and payable; and

(b) the release of all the company's liabilities under the relationship in respect of amounts which at that time are not yet due and payable.

12.9.7.FA 1996 S.86

Application of accounting methods.

(1) This section has effect, subject to the following provisions of this Chapter, for the determination of which of the alternative authorised accounting methods that are available by virtue of section 85 above is to be used as respects the loan relationships of a company.

(2) Different methods may be used as respects different relationships or, as respects the same relationship, for different accounting periods or for different parts of the same accounting period.

(3) If a basis of accounting which is or equates with an authorised accounting method is used as respects any loan relationship of a company in a company's statutory accounts, then the method which is to be used for the purposes of this Chapter as respects that relationship for the accounting period, or part of a period, for which that basis is used in those accounts shall be-

(a) where the basis used in those accounts is an authorised accounting method, that method; and

(b) where it is not, the authorised accounting method with which it equates.

(4) For any period or part of a period for which the authorised accounting method to be used as respects a loan relationship of a company is not determined under subsection (3) above, an authorised accruals basis of accounting shall be used for the purposes of this Chapter as respects that loan relationship.

(5) For the purposes of this section (but subject to subsection (6) below)-

(a) a basis of accounting equates with an authorised accruals basis of accounting if it purports to allocate payments under a loan relationship to accounting periods according to when they are taken to accrue; and

(b) a basis of accounting equates with an authorised mark to market basis of accounting if (without equating with an authorised accruals basis of accounting) it purports in respect of a loan relationship-

(i) to produce credits or debits computed by reference to the determination, as at different times in an accounting period, of a fair value; and

(ii) to produce credits or debits relating to payments under that relationship according to when they become due and payable.

(6) An accounting method which purports to make any such allocation of payments under a loan relationship as is mentioned in subsection (5)(a) above shall be taken for the purposes of this section to equate with an authorised mark to market basis of accounting (rather than with an authorised accruals basis of accounting) if-

(a) it purports to bring that relationship into account in each accounting period at a value which would be a fair value if the valuation were made on the basis that interest under the relationship were to be disregarded to the extent that it has already accrued; and

(b) the credits and debits produced in the case of that relationship by that method (when it is properly applied) correspond, for all practical purposes, to the credits and debits produced in the case of that relationship, and for the same accounting period, by an authorised mark to market basis of accounting.

(7) In this section "fair value" has the same meaning as in section 85 above.

(8) In this section "statutory accounts", in relation to a company, means-

(a) any accounts relating to that company that are drawn up in accordance with any requirements of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 that apply in relation to that company;

(b) any accounts relating to that company that are drawn up in accordance with any requirements of regulations under section 70 of the Friendly Societies Act 1992 that apply in relation to that company;

(c) any accounts relating to that company which are accounts to which Part I of Schedule 21C to the Companies Act 1985 or Part I of Schedule 21D to that Act (companies with UK branches) applies;

(d) in the case of a company which-

(i) is not subject to any such requirements as are mentioned in paragraphs (a) or (b) above, and

(ii) is a company in whose case there are no accounts for the period in question that fall within paragraph (c) above,

any accounts relating to the company drawn up in accordance with requirements imposed in relation to that company under the law of its home State; and

(e) in the case of a company which-

(i) is not subject to any such requirements as are mentioned in paragraphs (a), (b) or (d) above, and

(ii) is a company in whose case there are no accounts for the period in question that fall within paragraph (c) above,

the accounts relating to the company that most closely correspond to the accounts which, in the case of a company formed and registered under the Companies Act 1985, are required under that Act.

(9) For the purposes of subsection (8) above the home State of a company is the country or territory under whose law the company is incorporated.

12.9.8.FA 1996 S.87

Accounting methods where parties have a connection

(1) This section applies in the case of a loan relationship of a company where for any accounting period there is a connection between the company and-

(a) in the case of a debtor relationship of the company, a person standing in the position of a creditor as respects the debt in question; or

(b) in the case of a creditor relationship of the company, a person standing in the position of a debtor as respects that debt.

(2) The only accounting method authorised for the purposes of this Chapter for use by the company as respects the loan relationship shall be an authorised accruals basis of accounting.

(3) For the purposes of this section there is a connection between a company and another person for an accounting period if (subject to subsection (4) and section 88 below)-

(a) the other person is a company and there is a time in that period, or in the two years before the beginning of that period, when one of the companies has had control of the other;

(b) the other person is a company and there is a time in that period, or in those two years, when both the companies have been under the control of the same person; or

(c) there is a time in that accounting period, or in those two years, when the company was a close company and the other person was a participator in that company or the associate of a person who was such a participator at that time.

(4) Two companies which have at any time been under the control of the same person shall not, by virtue of that fact, be taken for the purposes of this section to be companies between whom there is a connection if the person was the Crown, a Minister of the Crown, a government department, a Northern Ireland department, a foreign sovereign power or an international organisation.

(5) The references in subsection (1) above to a person who stands in the position of a creditor or debtor as respects a loan relationship include references to a person who indirectly stands in that position by reference to a series of loan relationships.

(6) Subsections (2) to (6) of section 416 of the Taxes Act 1988 (meaning of "control") shall apply for the purposes of this section as they apply for the purposes of Part XI of that Act.

(7) Subject to subsection (8) below, in this section "participator" and "associate" have the meanings given for the purposes of Part XI of the Taxes Act 1988 by section 417 of that Act.

(8) A person shall not for the purposes of this section be regarded as a participator in relation to a company by reason only that he is a loan creditor of the company.

12.9.9.FA 1996 S.88

Exemption from section 87 in certain cases.

(1) Subject to subsection (5) below, where a creditor relationship of a company is one to which that company is a party in any accounting period in exempt circumstances, any connection for that accounting period between the company and a

person who stands in the position of a debtor as respects the debt shall be disregarded for the purposes of section 87 above.

(2) A company having a creditor relationship in any accounting period shall, for that period, be taken for the purposes of this section to be a party to that relationship in exempt circumstances if-

(a) the company, in the course of carrying on any activities forming an integral part of a trade carried on by that company in that period, disposes of or acquires assets representing creditor relationships;

(b) that period is one for which the company uses an authorised mark to market basis of accounting as respects all the creditor relationships represented by assets acquired in the course of those activities;

(c) the asset representing the creditor relationship in question was acquired in the course of those activities;

(d) that asset is either-

(i) listed on a recognised stock exchange at the end of that period; or

(ii) a security the redemption of which must occur within twelve months of its issue;

(e) there is a time in that period when assets of the same kind as the asset representing the loan relationship in question are in the beneficial ownership of persons other than the company; and

(f) there is not more than three months, in aggregate, in that accounting period during which the equivalent of 30 per cent. or more of the assets of that kind is in the beneficial ownership of connected persons.

(3) An insurance company carrying on basic life assurance and general annuity business and having a creditor relationship in any accounting period shall, for that period, be taken for the purposes of this section to be a party to that relationship in exempt circumstances if-

(a) assets of the company representing any of its creditor relationships are linked for that period to its basic life assurance and general annuity business;

(b) that period is one for which the company uses an authorised mark to market basis of accounting as respects all the creditor relationships of the company represented by assets that are so linked;

(c) the asset representing the creditor relationship in question is so linked;

(d) that asset is either-

(i) listed on a recognised stock exchange at the end of that period; or

(ii) a security the redemption of which must occur within twelve months of its issue;

(e) there is a time in that period when assets of the same kind as the asset representing the creditor relationship in question are in the beneficial ownership of persons other than the company; and

(f) there is not more than three months, in aggregate, in that accounting period during which the equivalent of 30 per cent. or more of the assets of that kind is in the beneficial ownership of connected persons.

(4) For the purposes of subsections (2) and (3) above-

(a) assets shall be taken to be of the same kind where they are treated as being of the same kind by the practice of any recognised stock exchange, or would be so treated if dealt with on such a stock exchange; and

(b) a connected person has the beneficial ownership of an asset wherever there is, or (apart from this section) would be, a connection (within the meaning of section 87 above) between-

(i) the person who has the beneficial ownership of the asset, and

(ii) a person who stands in the position of a debtor as respects the money debt by reference to which any loan relationship represented by that asset subsists.

(5) Where for any accounting period-

(a) subsection (1) above has effect in the case of a creditor relationship of a company, and

(b) the person who stands in the position of a debtor as respects the debt in question is also a company,

that subsection shall not apply for determining, for the purposes of so much of section 87 above as relates to the corresponding debtor relationship, whether there is a connection between the two companies.

(6) Subsection (5) of section 87 above shall apply for the purposes of this section as it applies for the purposes of that section.

(7) In this section "basic life assurance and general annuity business" and "insurance company" have the same meanings as in Chapter I of Part XII of the Taxes Act 1988, and section 432ZA of that Act (linked assets) shall apply for the purposes of this section as it applies for the purposes of that Chapter.

12.9.10. FA 1996 S.89

Inconsistent application of accounting methods.

(1) Where there is any inconsistency or other material difference between the way in which any authorised accounting method is applied as respects the same loan relationship in successive accounting periods, a balancing credit or balancing debit shall be brought into account in the second of those periods ("the second period").

(2) The amount of the balancing credit or debit shall be computed as respects the relationship in question by-

(a) taking the amount given by subsection (3) below and the amount given by subsection (4) below; and

(b) then aggregating those amounts (treating any debit as a negative amount) to produce a net credit or net debit.

(3) The amount given by this subsection is whichever of the following is applicable-

(a) a debit equal to the amount (if any) by which the first of the following amounts exceeds the second, that is to say-

(i) the aggregate of the credits actually brought into account for all previous periods in which the accounting method was used; and

(ii) the aggregate of the credits that would have been brought into account if that method had been applied in those periods in the same way as it was applied in the second period;

(b) a credit equal to the amount (if any) by which the second aggregate mentioned in paragraph (a) above exceeds the first; or

(c) if both those aggregates are the same, nil.

(4) The amount given by this subsection is whichever of the following is applicable-

(a) a credit equal to the amount (if any) by which the first of the following amounts exceeds the second, that is to say-

(i) the aggregate of the debits actually brought into account for all previous periods in which the accounting method was used; and

(ii) the aggregate of the debits that would have been brought into account if that method had been applied in those periods in the same way as it was applied in the second period;

(b) a debit equal to the amount (if any) by which the second aggregate mentioned in paragraph (a) above exceeds the first; or

(c) if both those aggregates are the same, nil.

(5) In this section "previous period" means any accounting period before the second period.

12.9.11. FA 1996 S.90

(1) This section applies where different authorised accounting methods are used for the purposes of this Chapter as respects the same loan relationship for different parts of the same accounting period or for successive accounting periods.

(2) Where, in the case of any loan relationship, the use of any authorised accounting method is superseded in the course of any accounting period by the use of another-

(a) the assumptions specified in subsection (4) below shall be made;

(b) each method shall be applied on those assumptions as respects the part of the period for which it is used; and

(c) the credits and debits given by the application of those methods on those assumptions shall be brought into account in the accounting period in which the change of method takes effect.

(3) Where, in the case of any loan relationship, the use of any authorised accounting method is superseded as from the beginning of an accounting period by the use of another-

(a) a net credit or debit shall be computed (treating any debit used in the computation as a negative amount) by-

(i) aggregating the credits and debits which, on the assumptions specified in subsection (4) below, would have been given in respect of that relationship for the successive accounting periods by the use for each period of the accounting method actually used for that period;

(ii) aggregating the credits and debits so given without the making of those assumptions; and

(iii) subtracting the second aggregate from the first;

and

(b) the net credit or debit shall be brought into account for the purposes of this Chapter in the accounting period as from the beginning of which the change of method takes effect.

(4) The assumptions mentioned in subsections (2) and (3) above are-

(a) that the company ceased to be a party to the relationship immediately before the end of the period, or part of a period, for which the superseded method is used;

(b) that the company again became a party to that relationship as from the beginning of the period or, as the case may be, part of a period for which the other authorised accounting method is used;

(c) that the relationship to which the company is deemed to have become a party is separate and distinct from the one to which it is deemed to have ceased to be a party;

(d) that the amount payable under the transaction comprised in each of the assumptions specified in paragraphs (a) and (b) above was equal to the fair value of the relationship; and

(e) so far as relevant, that that amount became due at the time when the company is deemed to have ceased to be a party to the relationship or, as the case may be, to have again become a party to it.

(5) Where-

(a) a mark to market basis of accounting is superseded by an accruals basis of accounting in the case of any loan relationship, and

(b) the amount which would have accrued in respect of that relationship in the period or part of a period for which the accruals basis of accounting is used falls to be determined for the purposes of this section in accordance with the assumptions mentioned in subsection (4) above,

that amount shall be taken for those purposes to be equal to the amount resulting from the subtraction of the amount given by subsection (6)(a) below from the amount given by subsection (6)(b) below.

(6) Those amounts are-

(a) the amount which by virtue of the assumptions mentioned in subsection (4) above is given as an opening value for the period or part of a period; and

(b) the amount equal to whatever, in the computation in accordance with an authorised accruals basis of accounting of the amount accruing in that period or part of a period, would have been taken to be the closing value applicable as at the end of that period or part of a period if such a basis of accounting had always been used as respects the relationship.

(7) In this section "fair value" has the same meaning as in section 85 above.

12.9.12.FA 1996 S.91

Payments subject to deduction of tax.

(1) This section applies where-

(a) any company receives a payment of interest on which it bears income tax by deduction; and

(b) in the case of that company, a credit relating to that interest has been brought into account for the purposes of this Chapter for an accounting period ending more than two years before the receipt of the payment.

(2) On a claim made by the company to an officer of the Board, section 7(2) or, as the case may be, 11(3) of the Taxes Act 1988 (deducted income tax to be set against liability to corporation tax) shall have effect in relation to the income tax on the payment as if the interest had fallen to be taken into account for the purposes of corporation tax in the accounting period in which the payment of that interest is received.

(3) In determining for the purposes of this section which accounting period is the accounting period for which a credit relating to interest paid subsequently was brought into account, every payment of interest to a company under a loan

relationship of that company shall be assumed to be a payment in discharge of the earliest outstanding liability to that company in respect of interest payable under the relationship.

(4) For the purposes of this section, the earliest outstanding liability to interest payable under a loan relationship of a company shall be identified, in relation to any payment of such interest, according to the authorised accounting method most recently used as respects that relationship, so that-

(a) if that method is an authorised accruals basis of accounting, it shall be determined by reference to the time when the interest accrued; and

(b) if that method is an authorised mark to market basis of accounting, it shall be determined by reference to the time when the interest became due and payable.

(5) In subsection (4) above the reference, in relation to a payment of interest made to a company in any accounting period, to the authorised accounting method most recently used as respects that relationship is a reference to the authorised accounting method which, in the case of that company, has been used as respects that relationship for the accounting period which, when the payment is made, is the most recent for which amounts in respect of that relationship have been brought into account for the purposes of this Chapter.

(6) A claim under this section shall not be made in respect of any payment of interest at any time after the later of the following, that is to say-

(a) the time two years after the end of the accounting period in which the payment is received; and

(b) the time six years after the end of the accounting period for which the credit in respect of the interest was brought into account for the purposes of this Chapter.

(7) Where-

(a) there is a payment of interest to a company under a loan relationship of that company, and

(b) the company is prevented by virtue of subsection (6) above from making any claim under this section in respect of that payment,

the company shall not be entitled to make any claim under paragraph 5 of Schedule 16 to the Taxes Act 1988 (set off of income tax borne against income tax payable) in respect of that payment.

12.9.13. FA 1996 S.92

Special cases Convertible securities etc.

(1) This section applies to an asset if-

(a) the asset represents a creditor relationship of a company;

(b) the rights attached to the asset include provision by virtue of which the company is or may become entitled to acquire (whether by conversion or exchange or otherwise) any shares in a company;

(c) the extent to which shares may be acquired under that provision is not determined using a cash value which is specified in that provision or which is or will be ascertainable by reference to the terms of that provision;

(d) the asset is not a relevant discounted security within the meaning of Schedule 13 to this Act;

(e) at the time when the asset came into existence there was a more than negligible likelihood that the right to acquire shares in a company would in due course be exercised to a significant extent; and

(f) the asset is not one the disposal of which by the company would fall to be treated as a disposal in the course of activities forming an integral part of a trade carried on by the company.

(2) The amounts falling for any accounting period to be brought into account for the purposes of this Chapter in respect of a creditor relationship represented by an asset to which this section applies shall be confined to amounts relating to interest.

(3) Only an authorised accruals basis of accounting shall be used for ascertaining those amounts.

(4) Amounts shall be brought into account in computing the profits of the company for the purposes of corporation tax as if the Taxation of Chargeable Gains Act 1992 had effect in relation to any asset to which this section applies as it has effect in relation to an asset that does not represent a loan relationship.

(5) For the purposes of that Act the amount or value of the consideration for any disposal or acquisition of the asset shall be treated as adjusted so as to exclude so much of it as, on a just and reasonable apportionment, relates to any interest which-

(a) falls to be brought into account under subsections (2) and (3) above as accruing to any company at any time; and

(b) in consequence of, or of the terms of, the disposal or acquisition, is not paid or payable to the company to which it is treated for the purposes of this Chapter as accruing.

(6) In subsection (5) above the references to a disposal, in relation to an asset, are references to anything which-

(a) is a disposal of that asset (within the meaning of the Taxation of Chargeable Gains Act 1992); or

(b) would be such a disposal but for section 127 or 116(10) of that Act (reorganisations etc.);

and the references to the acquisition of an asset shall be construed accordingly.

12.9.14.FA 1996 S.93

Relationships linked to the value of chargeable assets.

(1) This section applies in the case of any loan relationship of a company that is linked to the value of chargeable assets unless it is one the disposal of which by the company would fall to be treated as a disposal in the course of activities forming an integral part of a trade carried on by the company.

(2) The amounts falling for any accounting period to be brought into account for the purposes of this Chapter in respect of the relationship shall be confined to amounts relating to interest.

(3) Only an authorised accruals basis of accounting shall be used for ascertaining those amounts.

(4) Amounts shall be brought into account in computing the profits of the company for the purposes of corporation tax as if the Taxation of Chargeable Gains Act 1992 had effect in relation to the asset representing the relationship as it has effect in relation to an asset that does not represent a loan relationship.

(5) For the purposes of that Act the amount or value of the consideration for any disposal or acquisition of the asset shall be treated as adjusted so as to exclude so much of it as, on a just and reasonable apportionment, relates to any interest which-

(a) falls to be brought into account under subsections (2) and (3) above as accruing to any company at any time; and

(b) in consequence of, or of the terms of, the disposal or acquisition, is not paid or payable to the company to which it is treated for the purposes of this Chapter as accruing.

(6) For the purposes of this section a loan relationship is linked to the value of chargeable assets if, in pursuance of any provision having effect for the purposes of that relationship, the amount that must be paid to discharge the money debt (whether on redemption of a security issued in relation to that debt or otherwise) is equal to the amount determined by applying a relevant percentage change in the value of chargeable assets to the amount falling for the purposes of this Chapter to be regarded as the amount of the original loan from which the money debt arises.

(7) In subsection (6) above the reference to a relevant percentage change in the value of chargeable assets is a reference to the amount of the percentage change (if any) over the relevant period in the value of chargeable assets of any particular description or in any index of the value of any such assets.

(8) In subsection (7) above "the relevant period" means-

(a) the period between the time of the original loan and the discharge of the money debt; or

(b) any other period in which almost all of that period is comprised and which differs from that period exclusively for purposes connected with giving effect to a valuation in relation to rights or liabilities under the loan relationship.

(9) If-

(a) there is a provision which, in the case of any loan relationship, falls within subsection (6) above,

(b) that provision is made subject to any other provision applying to the determination of the amount payable to discharge the money debt,

(c) that other provision is to the effect only that the amount so payable must not be less than a specified percentage of the amount falling for the purposes of this Chapter to be regarded as the amount of the original loan, and

(d) the specified percentage is not more than 10 per cent.,

that other provision shall be disregarded in determining for the purposes of this section whether the relationship is linked to the value of chargeable assets.

(10) For the purposes of this section an asset is a chargeable asset, in relation to a loan relationship of a company, if any gain accruing on the disposal of the asset by the company on or after 1st April 1996 would, on the assumptions specified in subsection (11) below, be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act 1992.

(11) Those assumptions are-

(a) where it is not otherwise the case, that the asset is an asset of the company;

(b) that the asset is not one the disposal of which by the company would fall to be treated for the purposes of corporation tax as a disposal in the course of a trade carried on by the company; and

(c) that chargeable gains that might accrue under section 116(10) of that Act (postponed charges) are to be disregarded.

(12) In subsection (5) above references to a disposal, in relation to an asset, are references to anything which-

(a) is a disposal of that asset (within the meaning of the Taxation of Chargeable Gains Act 1992); or

(b) would be such a disposal but for section 127 or 116(10) of that Act (reorganisations etc.);

and the references to the acquisition of an asset shall be construed accordingly.

(13) For the purposes of this section neither-

(a) the retail prices index, nor

(b) any similar general index of prices published by the government of any territory or by the agent of any such government,

shall be taken to be an index of the value of chargeable assets.

12.9.15. FA 1996 S.94

Indexed gilt-edged securities.

(1) In the case of any loan relationship represented by an index-linked gilt-edged security, the adjustment for which this section provides shall be made in computing the credits and debits which fall, for any accounting period, to be brought into account for the purposes of this Chapter in respect of that relationship as non-trading credits or non-trading debits.

(2) The adjustment shall be made wherever-

(a) the authorised accounting method applied as respects the index-linked gilt-edged security gives credits or debits by reference to the value of the security at two different times, and

(b) there is any change in the retail prices index between those times.

(3) Subject to subsection (4) below, the adjustment is such an adjustment of the amount which would otherwise be taken for the purposes of that accounting method to be the value of the security at the earlier time ("the opening value") as results in the amount in fact so taken being equal to the opening value increased or, as the case may be, reduced by the same percentage as the percentage increase or reduction in the retail prices index between the earlier and the later time.

(4) The Treasury may, in relation to any description of index-linked gilt-edged securities, by order provide that-

(a) there are to be no adjustments under this section; or

(b) that an adjustment specified in the order (instead of the adjustment specified in subsection (3) above) is to be the adjustment for which this section provides.

(5) An order under subsection (4) above-

(a) shall not have effect in relation to any gilt-edged security issued before the making of the order; but

(b) may make different provision for different descriptions of securities.

(6) For the purposes of this section the percentage increase or reduction in the retail prices index between any two times shall be determined by reference to the difference between-

(a) that index for the month in which the earlier time falls; and

(b) that index for the month in which the later time falls.

(7) In this section "index-linked gilt-edged securities" means any gilt-edged securities the amounts of the payments under which are determined wholly or partly by reference to the retail prices index.

12.9.16.FA 1996 S.95

Gilt strips.

(1) This section has effect for the purposes of the application of an authorised accruals basis of accounting as respects a loan relationship represented by a gilt-edged security or a strip of a gilt-edged security.

(2) Where a gilt-edged security is exchanged by any person for strips of that security-

(a) the security shall be deemed to have been redeemed at the time of the exchange by the payment to that person of its market value; and

(b) that person shall be deemed to have acquired each strip for the amount which bears the same proportion to that market value as is borne by the market value of the strip to the aggregate of the market values of all the strips received in exchange for the security.

(3) Where strips of a gilt-edged security are consolidated into a single gilt-edged security by being exchanged by any person for that security-

(a) each of the strips shall be deemed to have been redeemed at the time of the exchange by the payment to that person of the amount equal to its market value; and

(b) that person shall be deemed to have acquired the security received in the exchange for the amount equal to the aggregate of the market values of the strips given in exchange for the security.

(4) References in this section to the market value of a security given or received in exchange for another are references to its market value at the time of the exchange.

(5) Without prejudice to the generality of any power conferred by section 202 below, the Treasury may by regulations make provision for the purposes of this section as to the manner of determining the market value at any time of any gilt-edged security (including any strip).

(6) Regulations under subsection (5) above may-

(a) make different provision for different cases; and

(b) contain such incidental, supplemental, consequential and transitional provision as the Treasury may think fit.

(7) In this section "strip" means anything which, within the meaning of section 47 of the Finance Act 1942, is a strip of a gilt-edged security.

12.9.17.FA 1996 S.96

Special rules for certain other gilts.

(1) This section applies as respects any loan relationship of a company if-

(a) it is represented by a security of any of the following descriptions-

(i) 3½% Funding Stock 1999-2004; or

(ii) 5½% Treasury Stock 2008-2012;

and

(b) it is one to which the company is a party otherwise than in the course of activities that form an integral part of a trade carried on by the company.

(2) The amounts falling for any accounting period to be brought into account for the purposes of this Chapter in respect of a loan relationship to which this section applies shall be confined to amounts relating to interest.

(3) Only an authorised accruals basis of accounting shall be used for ascertaining those amounts.

12.9.18.FA 1996 S.97

Manufactured interest.

(1) This section applies where-

(a) any amount ("manufactured interest") is payable by or on behalf of, or to, any company under any contract or arrangements relating to the transfer of an asset representing a loan relationship; and

(b) that amount is, or (when paid) will fall to be treated as, representative of interest under that relationship ("the real interest").

(2) In relation to that company the manufactured interest shall be treated for the purposes of this Chapter-

(a) as if it were interest under a loan relationship to which the company is a party; and

(b) where that company is the company to which the manufactured interest is payable, as if that relationship were the one under which the real interest is payable.

(3) Any question whether debits or credits falling to be brought into account in the case of any company by virtue of this section-

(a) are to be brought into account under section 82(2) above, or

(b) are to be treated as non-trading debits or non-trading credits,

shall be determined according to the extent (if any) to which the manufactured interest is paid for the purposes of a trade carried on by the company or is received in the course of activities forming an integral part of such a trade.

(4) Where section 737A(5) of the Taxes Act 1988 (deemed manufactured payments) has effect in relation to a transaction relating to an asset representing a loan relationship so as, for the purposes of section 737 of, or Schedule 23A to, that Act, to deem there to have been a payment representative of interest under that relationship, this section shall apply as it would have applied if such a representative payment had in fact been made.

(5) This section does not apply where the manufactured interest is treated by virtue of paragraph 5(2)(c) or (4)(c) of Schedule 23A to the Taxes Act 1988 (manufactured interest passing through the market) as not being income of the person who receives it.

12.9.19.FA 1996 S.100

Miscellaneous other provisions Interest on judgments, imputed interest, etc.

(1) This Chapter shall have effect in accordance with subsection (2) below where-

(a) interest on a money debt is payable to or by any company;

(b) that debt is one as respects which it stands, or has stood, in the position of a creditor or debtor; and

(c) that debt did not arise from a loan relationship.

(2) It shall be assumed for the purposes of this Chapter-

(a) that the interest is interest payable under a loan relationship to which the company is a party; but

(b) that the only credits or debits to be brought into account for those purposes in respect of that relationship are those relating to the interest.

(3) References in this section to interest payable on a money debt include references to any amount which, in pursuance of sections 770 to 772 of the Taxes Act 1988 (transactions at an undervalue or overvalue), as those sections have effect by virtue of section 773(4) of that Act, falls to be treated in pursuance of those sections as-

(a) interest on a money debt; or

(b) interest on an amount which is treated as a money debt.

(4) Any question whether debits or credits falling to be brought into account in accordance with this section in relation to any company-

(a) are to be brought into account under section 82(2) above, or

(b) are to be treated as non-trading debits or non-trading credits,

shall be determined according to the extent (if any) to which the interest in question is paid for the purposes of a trade carried on by the company or is received in the course of activities forming an integral part of such a trade, or (in the case of deemed interest) would be deemed to be so paid or received.

(5) This section has effect subject to the provisions of Schedules 9 and 11 to this Act.

12.9.20.FA 1996 S.101

Financial instruments.

(1) Chapter II of Part IV of the Finance Act 1994 (provisions relating to certain financial instruments) shall not apply to any profit or loss which, in accordance with that Chapter, accrues to a company for any accounting period on a qualifying contract by virtue of which the company is a party to any loan relationship if-

(a) an amount representing that profit or loss, or

(b) an amount representing the profit or loss accruing to that company on that contract,

is brought into account for that period for the purposes of this Chapter.

(2) After section 147 of that Act (qualifying contracts) there shall be inserted the following section-

"Debt contracts and options to be qualifying contracts.

147A. - (1) For the purposes of this Chapter a debt contract or option is a qualifying contract as regards a qualifying company if the company becomes entitled to rights, or subject to duties, under the contract or option at any time on or after 1st April 1996.

(2) For the purposes of this Chapter a qualifying company which is entitled to rights, or subject to duties, under a debt contract or option both immediately before and on 1st April 1996 shall be deemed to have become entitled or subject to those rights or duties on that date.

(3) This section has effect subject to paragraph 25 of Schedule 15 to the Finance Act 1996 (transitional provisions)."

(3) After section 150 of that Act (qualifying contracts) there shall be inserted the section set out in Schedule 12 to this Act (which defines debt contracts and options by reference to contracts and options conferring rights and duties to participate in loan relationships).

(4) In section 151 of that Act (provisions that may be included in contracts and options), for the words "or a currency contract or option,", in each place where they occur, there shall be substituted "a currency contract or option or a debt contract or option".

(5) In section 152(1) of that Act (disregard of provisions for relatively small payments in contracts and options), after "150" there shall be inserted "or 150A".

(6) In section 153(1) of that Act (qualifying payments), for the word "and" at the end of paragraph (c) there shall be substituted-

"(ca) in relation to a qualifying contract which is a debt contract, a payment falling within section 150A(5) or (6) above; and".

12.9.21. FA 1996 S.102

Discounted securities: income tax provisions.

Schedule 13 to this Act (which, in connection with the provisions of this Chapter relating to corporation tax, makes provision for income tax purposes about discounted securities) shall have effect.

12.9.22. FA 1996 S.103

Supplemental Interpretation of Chapter.

(1) In this Chapter-

"authorised accounting method", "authorised accruals basis of accounting" and "authorised mark to market basis of accounting" shall be construed in accordance with section 85 above;

"creditor relationship", in relation to a company, means any loan relationship of that company in the case of which it stands in the position of a creditor as respects the debt in question;

"debt" includes a debt the amount of which falls to be ascertained by reference to matters which vary from time to time;

"debtor relationship", in relation to a company, means any loan relationship of that company in the case of which it stands in the position of a debtor as respects the debt in question;

"gilt-edged securities" means any securities which-

(a) are gilt-edged securities for the purposes of the Taxation of Chargeable Gains Act 1992; or

(b) will be such securities on the making of any order under paragraph 1 of Schedule 9 to that Act the making of which is anticipated in the prospectus under which they are issued;

"an independent person" means a knowledgeable and willing party dealing at arm's length;

"international organisation" means an organisation of which two or more sovereign powers, or the governments of two or more sovereign powers, are members;

"loan" includes any advance of money, and cognate expressions shall be construed accordingly;

"money" shall be construed in accordance with section 81(6) above and subsection (5) below;

"money debt" shall be construed in accordance with section 81(2) above;

"non-trading credit" and "non-trading debit" shall be construed in accordance with section 82(3) above;

"retail prices index" has the same meaning as it has, by virtue of section 833(2) of the Taxes Act 1988, in the Income Tax Acts;

"share", in relation to a company, means any share in the company under which an entitlement to receive distributions may arise.

(2) For the purposes of this Chapter a company shall be taken to be a party to a creditor relationship for the purposes of a trade carried on by that company only if it is a party to that relationship in the course of activities forming an integral part of that trade.

(3) For the purposes of this Chapter, and of so much of any other enactment as contains provision by reference to which amounts fall to be brought into account for the purposes of this Chapter, activities carried on by a company in the course of-

(a) any mutual trading, or

(b) any mutual insurance or other mutual business which is not life assurance business (within the meaning of Chapter I of Part XII of the Taxes Act 1988),

shall be deemed not to constitute the whole or any part of a trade.

(4) If, in any proceedings, any question arises whether a person is an international organisation for the purposes of any provision of this Chapter, a certificate issued by or under the authority of the Secretary of State stating any fact relevant to that question shall be conclusive evidence of that fact.

(5) For the purposes of this Chapter the European currency unit (as for the time being defined in Council Regulation No. 3180/78/EEC or in any Community instrument replacing it) shall be taken to be a currency other than sterling.

12.9.23.FA 1996 S.104

Minor and consequential amendments.

Schedule 14 to this Act (which, for the purposes of both corporation tax and income tax, makes certain minor and consequential amendments in connection with the provisions of this Chapter) shall have effect.

12.9.24.FA 1996 S.105

Commencement and transitional provisions.

(1) Subject to Schedule 15 to this Act, this Chapter has effect-

(a) for the purposes of corporation tax, in relation to accounting periods ending after 31st March 1996; and

(b) so far as it makes provision for the purposes of income tax, in relation to the year 1996-97 and subsequent years of assessment.

(2) Schedule 15 to this Act (which contains transitional provisions and savings in connection with the coming into force of this Chapter) shall have effect.

12.9.25.FA 1996 S.202

Miscellaneous: other matters: Gilt stripping.

(1) In section 47 of the Finance Act 1942 (Treasury regulations with respect to the transfer and registration of Government stock), after paragraph (bb) of subsection (1) there shall be inserted the following paragraphs-

"(bc) for the exchange of any such stock and bonds (whenever issued) for strips thereof;

(bd) for exchanges by which such strips (whether deriving from the same security or from different securities) are consolidated into a single security of a description so specified;".

(2) After subsection (1A) of that section (transfer of deceased persons' stocks and bonds) there shall be inserted the following subsections-

"(1B) In this section "strip", in relation to any stock or bond, means a security issued under the National Loans Act 1968 which-

(a) is issued for the purpose of representing the right to, or of securing-

(i) a payment corresponding to a payment of interest or principal remaining to be made under the stock or bond, or

(ii) two or more payments each corresponding to a different payment remaining to be so made;

(b) is issued in conjunction with the issue of one or more other securities which, together with that security, represent the right to, or secure, payments corresponding to every payment remaining to be made under the stock or bond; and

(c) is not itself a security that represents the right to, or secures, payments corresponding to a part of every payment so remaining.

(1C) For the purposes of subsection (1B) of this section, where the balance has been struck for a dividend on any stock or bond, any payment to be made in respect of that dividend shall, at times falling after that balance has been struck, be treated as not being a payment remaining to be made under the stock or bond.

(1D) Without prejudice to the generality of the powers conferred by the preceding provisions of this section (but subject to subsection (1E) of this section), regulations made by virtue of paragraph (bc) or (bd) of subsection (1) of this section may-

(a) provide, for the purpose of authorising the making of exchanges, for any stock or bonds to be treated as issued on such terms as may be specified in the regulations;

(b) contain such provision as the Treasury think fit about the circumstances in which and the conditions subject to which exchanges may be effected; and

(c) contain any such provision as could be contained in rules made under section 14(3) of the National Loans Act 1968 (Treasury rules as to exchange of securities).

(1E) Regulations made by virtue of subsection (1)(bc) or (bd) of this section shall not make provision for the exchange of any stock or bonds, or of any strips, in any cases other than those where the exchange is at the request of the holder or in accordance with an order made by a court.

(1F) Regulations under this section may make different provision for different cases and contain such exceptions and exclusions as the Treasury think fit; and the powers of the Treasury to make regulations under this section are without prejudice to any of their powers under the National Loans Act 1968."

(3) After section 2 of the National Debt (Stockholders Relief) Act 1892 (date for striking balance for a dividend on stock) there shall be inserted the following section-

"Payment of dividend on stock stripped after balance struck.

2A. - (1) Where-

(a) any stock is exchanged for strips of that stock, and

(b) that exchange takes place after the balance has been struck for a dividend on that stock but before the day on which that dividend is payable,

any person who would have been entitled to that dividend but for the exchange shall remain entitled to that dividend notwithstanding the exchange.

(2) The Treasury may by order made by statutory instrument provide that for the purposes of this section and section 47(1C) of the Finance Act 1942, the balance for any dividend on any stock is to be deemed to be struck at a time which, by such a period as is specified in the order, precedes the time when the balance is actually struck.

(3) A period specified in an order under subsection (2) above shall not exceed 7 days; and an order made under that subsection may make different provision for different cases.

(4) In this section "strip", in relation to any stock, has the meaning given by section 47 of the Finance Act 1942."

(4) In section 16 of the National Loans Act 1968 (supplemental provisions as to national debt), after subsection (4) there shall be inserted the following subsection-

"(4A) In subsections (3) and (4) above the references to stock or registered bonds issued under this Act include references to a strip (within the meaning of section 47 of the Finance Act 1942) of any stock or bond (whether the stock or bond is issued under this Act or otherwise)."

(5) The Treasury may by regulations make provision for securing that enactments and subordinate legislation which-

(a) apply in relation to government securities or to any description of such securities, or

(b) for any other purpose refer (in whatever terms) to such securities or to any description of them,

have effect with such modifications as the Treasury may think appropriate in consequence of the making of any provision or arrangements for, or in connection with, the issue or transfer of strips of government securities or the consolidation of such strips into other securities.

(6) Regulations under subsection (5) above may-

(a) impose a charge to income tax, corporation tax, capital gains tax, inheritance tax, stamp duty or stamp duty reserve tax;

(b) include provision applying generally to, or to any description of, enactments or subordinate legislation;

(c) make different provision for different cases; and

(d) contain such incidental, supplemental, consequential and transitional provision as the Treasury think appropriate.

(7) The power to make regulations under subsection (5) above shall be exercisable by statutory instrument subject to annulment in pursuance of a resolution of the House of Commons.

(8) Schedule 40 to this Act (which makes provision in relation to strips for taxation purposes) shall have effect.

(9) The enactments that may be modified by regulations under this section shall include section 95 above and the enactments contained in Schedule 40 to this Act.

(10) In this section-

"government securities" means any securities included in Part I of Schedule 11 to the Finance Act 1942;

"modifications" includes amendments, additions and omissions; and

"subordinate legislation" has the same meaning as in the Interpretation Act 1978;

and expressions used in this section and in section 47 of the Finance Act 1942 have the same meanings in this section as in that section.

12.9.26. FA 1996 SCHEDULE 8

Loan relationships: claims relating to deficits

12.9.26.1. FA 1996 Sch.8 para.1

Claim to set off deficit against other profits for the deficit period

(1) This paragraph applies where a claim is made under section 83(2)(a) of this Act for the whole or any part of the deficit to be set off against profits of any description for the deficit period.

(2) Subject to the following provisions of this paragraph-

(a) the amount to which the claim relates shall be set off against the profits of the company for the deficit period that are identified in the claim; and

(b) those profits shall be treated as reduced accordingly.

(3) Any reduction by virtue of sub-paragraph (2) above shall be made-

(a) after relief has been given for any loss incurred in a trade in an earlier accounting period; and

(b) before any relief is given against profits for that period either-

(i) under section 393A(1) of the Taxes Act 1988 (trading losses set against profits for the same or preceding accounting periods); or

(ii) by virtue of any claim made, in respect of a deficit for a subsequent period, under section 83(2)(c) of this Act.

(4) Relief shall not be given by virtue of a claim under section 83(2)(a) of this Act against any ring fence profits of the company within the meaning of Chapter V of Part XII of the Taxes Act 1988 (petroleum extraction activities).

12.9.26.2.FA 1996 Sch.8 para.2

Claim to treat deficit as eligible for group relief

(1) This paragraph applies where the company makes a claim under section 83(2)(b) of this Act for the whole or any part of the deficit to be treated as eligible for group relief.

(2) The amount to which the claim relates shall be treated as if, for the purposes of subsection (1) of section 403 of the Taxes Act 1988 (group relief for trades)-

(a) it were a loss incurred in the deficit period by a company carrying on a trade; and

(b) the exclusions in subsection (2) of that section did not apply.

12.9.26.3.FA 1996 Sch.8 para.3

Claim to carry back deficit to previous accounting periods

(1) This paragraph applies where a claim is made under section 83(2)(c) of this Act for the whole or any part of the deficit to be carried back to be set off against profits for earlier accounting periods.

(2) The claim shall have effect only if it relates to an amount that is equal to whichever is smaller of the following amounts, that is to say-

(a) so much of that deficit as is neither-

(i) an amount in relation to which a claim is made under subsection (2)(a) or (b) of section 83 of this Act, nor

(ii) an amount excluded by virtue of subsection (4) of that section from the amounts in relation to which claims may be made under subsection (2) of that section;

and

(b) the total amount of the profits available for relief under this paragraph.

(3) Where the claim has effect, the amount to which the claim relates shall be set off against the profits available for relief under this paragraph-

(a) by treating those profits as reduced accordingly; and

(b) to the extent that those profits are profits for more than one accounting period, by applying the relief to profits for a later period before setting off any remainder of the amount to which the claim relates against profits for an earlier period.

(4) Subject to sub-paragraph (5) below, the profits available for relief under this paragraph are the amounts which, for accounting periods ending within the permitted period, would be taken-

(a) apart from any relief under this paragraph, and

(b) after the giving of every relief which under sub-paragraph (6) below falls to be given in priority to relief under this paragraph,

to be chargeable under Case III of Schedule D as profits and gains arising from the company's loan relationships.

(5) Where any accounting period begins before the beginning of the permitted period but ends in the course of it-

(a) any amount chargeable in respect of that accounting period under Case III of Schedule D as profits and gains of the company's loan relationships shall be apportioned according to the proportions of the accounting period falling before and after the beginning of the permitted period; and

(b) the amount attributable, on that apportionment, to before the beginning of the permitted period shall not be available for relief under this paragraph.

(6) The reliefs which fall to be given in priority to relief under this paragraph in respect of any loss are-

(a) any relief in respect of a loss or deficit incurred or treated as incurred in an accounting period before the deficit period;

(b) any relief under section 338 of the Taxes Act 1988 (charges on income) in respect of payments made wholly and exclusively for the purposes of a trade;

(c) where the company is an investment company for the purposes of Part IV of that Act-

(i) any allowance under section 28 of the Capital Allowances Act 1990 (machinery and plant of investment companies);

(ii) any deduction in respect of management expenses under section 75 of the Taxes Act 1988; and

(iii) any relief under section 338 of the Taxes Act 1988 in respect of payments made wholly and exclusively for the purposes of its business;

(d) any relief under section 393A of the Taxes Act 1988 (trading losses set against profits of the same or any preceding accounting periods); and

(e) any relief in pursuance of a claim under section 83(2)(a) or (b) of this Act.

(7) In this paragraph "the permitted period" means the period of three years immediately preceding the beginning of the deficit period so far as that three year period falls after 31st March 1996.

12.9.26.4.FA 1996 Sch.8 para.4

Claim to carry forward deficit to next accounting period

This paragraph applies where a claim is made under section 83(2)(d) of this Act for the whole or any part of the deficit to be carried forward and set against non-trading profits for the next accounting period.

(2) The amount to which the claim relates shall be set off against the non-trading profits of the company for the accounting period immediately following the deficit period, and those profits shall be treated as reduced accordingly.

(3) In this paragraph "non-trading profits", in relation to a company, means so much of any profits of the company (of whatever description) as do not consist in trading income for the purposes of section 393A of the Taxes Act 1988 (setting-off of trading losses against profits of the same or an earlier period).

12.9.26.5.FA 1996 Sch.8 para.5

Construction of Schedule

In this Schedule "the deficit" and "the deficit period" shall be construed by reference to section 83(1) of this Act.

12.9.27.FA 1996 SCHEDULE 9

Loan relationships: special computational provisions

12.9.27.1.FA 1996 Sch.9 para.1

Distributions

The credits and debits to be brought into account for the purposes of this Chapter shall not include any credits or debits relating to any amount falling, when paid, to be treated as a distribution.

12.9.27.2.FA 1996 Sch.9 para.2

Late interest

(1) This paragraph applies for the purpose of bringing debits into account for the purposes of this Chapter in respect of a debtor relationship of a company where an authorised accruals basis of accounting is used as respects that relationship in pursuance of section 87 of this Act.

(2) If-

(a) interest payable under that relationship is not paid within the period of twelve months following the end of the accounting period in which it would (apart from this paragraph) be treated as accruing, and

(b) credits representing the full amount of the interest are not for any accounting period brought into account for the purposes of this Chapter in respect of the corresponding creditor relationship,

then debits relating to that interest shall be brought into account on the assumption that the interest does not accrue until it is paid.

12.9.27.3.FA 1996 Sch.9 para.3

Options etc.

(1) This paragraph applies for determining the credits and debits to be brought into account for any accounting period in accordance with an authorised accruals basis of accounting, where-

(a) the answer to the question whether any amount will become due under a loan relationship after the end of that period,

(b) the amount which will become due under a loan relationship after the end of that period, or

(c) the time after the end of that period when an amount will become due under a loan relationship,

depends on the exercise of an option by a party to the relationship or an associate of his, or is otherwise under the control of such a party or an associate of his.

(2) It shall be assumed that the party or his associate will exercise his power to determine whether and on what date any amount will become due in the manner which (apart from taxation) appears, as at the end of the accounting period in question, to be the most advantageous to that party.

(3) In this paragraph "associate" has the meaning given for the purposes of Part XI of the Taxes Act 1988 by section 417(3) and (4) of that Act.

12.9.27.4.FA 1996 Sch.9 para.4

Foreign exchange gains and losses

(1) The credits and debits to be brought into account for the purposes of this Chapter shall be computed disregarding so much of any authorised accounting method as, by requiring the translation or conversion of amounts from one currency into another, has the effect that credits and debits produced by that method include sums in which profits, gains or losses arising from fluctuations in the value of a currency are to any extent represented.

(2) This paragraph is without prejudice to the provisions of Chapter II of Part II of the Finance Act 1993 (exchange gains and losses).

12.9.27.5.FA 1996 Sch.9 para.5

Bad debt etc.

(1) In determining the credits and debits to be brought into account in accordance with an accruals basis of accounting, a departure from the assumption in the case of the creditor relationships of a company that every amount payable under those relationships will be paid in full as it becomes due shall be allowed (subject to paragraph 6 below) to the extent only that-

(a) a debt is a bad debt;

(b) a doubtful debt is estimated to be bad; or

(c) a liability to pay any amount is released.

(2) Such a departure shall be made only where the accounting arrangements allowing the departure also require appropriate adjustments, in the form of credits, to be made if the whole or any part of an amount taken or estimated to represent an amount of bad debt is paid or otherwise ceases to be an amount in respect of which such a departure is allowed.

(3) Where-

(a) a liability to pay any amount under a debtor relationship of a company is released, and

(b) the release takes place in an accounting period for which an authorised accruals basis of accounting is used as respects that relationship,

no credit in respect of the release shall be required to be brought into account in the case of that company if the release is part of a relevant arrangement or compromise (within the meaning given by section 74(2) of the Taxes Act 1988) or the relationship is one as respects which section 87 of this Act requires the use of an authorised accruals basis of accounting.

12.9.27.6.FA 1996 Sch.9 para.6

Bad debt etc. where parties have a connection

(1) This paragraph applies where for any accounting period section 87 of this Act requires an authorised accruals basis of accounting to be used as respects a creditor relationship of a company.

(2) The credits and debits which for that period are to be brought into account for the purposes of this Chapter in accordance with that accounting method shall be computed subject to sub-paragraphs (3) to (6) below.

(3) The assumption that every amount payable under the relationship will be paid in full shall be applied as if no departure from that assumption were authorised by virtue of paragraph 5 above except where it is allowed by sub-paragraph (4) below.

(4) A departure from that assumption shall be allowed in relation to a liability to pay any amount to the company ("the creditor company") under the creditor relationship where-

(a) in consideration of, or of any entitlement to, any shares forming part of the ordinary share capital of the company on whom the liability would otherwise have fallen, the creditor company treats the liability as discharged; and

(b) the condition specified in sub-paragraph (5) below is satisfied.

(5) That condition is that there would be no connection between the two companies for the accounting period in which that consideration is given if the question whether there is such a connection for that period fell to be determined, in accordance with section 87 of this Act, by reference only to times before the creditor company acquired possession of, or any entitlement to, the shares in question.

(6) Where the company ceases in the accounting period in question to be a party to the relationship-

(a) the debits brought into account for that period in respect of that relationship shall not (subject to sub-paragraph (7) below) be more than they would have been had the company not ceased to be a party to the relationship; and

(b) the credits brought into account for that period in respect of the relationship shall not (subject to that sub-paragraph) be less than they would have been in those circumstances.

(7) In determining for the purposes of sub-paragraph (6) above the debits and credits that would have been brought into account if a company had not ceased to be a party to a loan relationship, no account shall be taken of any amounts that would have accrued at times after it ceased to be a party to the relationship.

12.9.27.7.FA 1996 Sch.9 para.7

Writing-off of government investments

(1) Where any government investment in a company is written off by the release of a liability to pay any amount under a debtor relationship of the company, no credit shall be required, in the case of that company, to be brought into account for the purposes of this Chapter in respect of that release.

(2) Subsections (7) and (8) of section 400 of the Taxes Act 1988 shall apply, as they apply for the purposes of that section, for construing the reference in sub-paragraph (1) above to the writing-off of a government investment.

12.9.27.8.FA 1996 Sch.9 para.8

Restriction on writing off overseas sovereign debt etc.

(1) This paragraph applies for the purposes of the use, as respects any loan relationship of a company and in conformity with paragraph 5 above, of an authorised accruals basis of accounting.

(2) Where the company is one to which a relevant overseas debt is owed, the debits and credits to be brought into account on that basis for the purposes of this Chapter shall be determined, for any accounting period of the company, on the assumption that it is not permissible for more than the relevant percentage of the debt to be estimated to be bad.

(3) For the purposes of this paragraph the relevant percentage of a debt for any accounting period of a company is (subject to sub-paragraph (4) below) such percentage (which may be zero) as may be determined, by reference to the position at the end of the relevant period of account, in accordance with regulations made by the Treasury.

(4) Where, apart from this sub-paragraph, the relevant percentage of a debt for any accounting period is more than the adjusted base percentage of that debt for that period, the relevant percentage of the debt for that period shall be taken to be equal to its adjusted base percentage for that period.

(5) For the purposes of this paragraph the adjusted base percentage of a debt for any accounting period shall be calculated by-

(a) taking the percentage which, in accordance with section 88B of the Taxes Act 1988 and any regulations made under that section, was or (assuming the debt to have been a debt of the company at the end of the base period) would have been the base percentage for that debt; and

(b) increasing that base percentage by five percentage points for every complete year (except the first) between-

(i) the time by reference to which the base percentage was, or would have been, determined, and

(ii) the end of the relevant period of account.

(6) In this paragraph "the relevant period of account", in relation to any accounting period of a company, means the period of account ending with that accounting period or, if a period of account does not end with that accounting period, the last period of account of the company to end before the end of that accounting period.

(7) In this paragraph "relevant overseas debt" means any debt which-

(a) satisfies one of the conditions specified in sub-paragraph (8) below; but

(b) is neither interest on a debt nor a debt which represents the consideration for the provision of goods or services.

(8) Those conditions are-

(a) that the debt is owed by an overseas State authority; or

(b) that payment of the debt is guaranteed by an overseas State authority; or

(c) that the debt is estimated to be bad for the purposes of this Chapter wholly or mainly because due payment is or may be prevented, restricted or subjected to conditions-

(i) by virtue of any law of a State or other territory outside the United Kingdom or any act of an overseas State authority; or

(ii) under any agreement entered into in consequence or anticipation of such a law or act.

(9) In this paragraph "overseas State authority" means-

(a) a State or other territory outside the United Kingdom;

(b) the government of such a State or territory;

(c) the central bank or other monetary authority of such a State or territory;

(d) a public or local authority in such a State or territory; or

(e) a body controlled by such a State, territory, government, bank or authority;

and for this purpose "controlled" shall be construed in accordance with section 840 of the Taxes Act 1988.

(10) The Treasury shall not make any regulations under this paragraph unless a draft of them has been laid before and approved by a resolution of the House of Commons.

12.9.27.9.FA 1996 Sch.9 para.9

Further restriction on bringing into account losses on overseas sovereign debt etc.

(1) This paragraph applies where-

(a) for an accounting period in which a company ceases to be a party to a loan relationship ("the loss period") any amount falls for the purposes of this Chapter to be brought into account in respect of that relationship in accordance with an authorised accruals basis of accounting;

(b) by the bringing into account of that amount in that period a loss incurred in connection with a relevant overseas debt falling within sub-paragraph (2) below is treated for the purposes of this Chapter as arising in that period;

(c) the amount of the loss is greater than 5 per cent. of the debt; and

(d) the loss is not one incurred on a disposal of the debt to an overseas State authority in a case in which the State or territory by reference to which it is an overseas State authority is the same as that by reference to which the debt is a relevant overseas debt.

(2) A relevant overseas debt falls within this sub-paragraph if-

(a) a deduction has been made in respect of the debt in accordance with section 74(1)(j) of the Taxes Act 1988 for any period of account of the company ending before 1st April 1996;

(b) any debit relating to the debt has been brought into account for the purposes of this Chapter in accordance with so much of any authorised accruals basis of accounting as relates to the matters mentioned in paragraph 5(1)(a) to (c) above; or

(c) the debt is one acquired by the company on or after 20th March 1990 for a consideration greater than the price which it might reasonably have been expected to fetch on a sale in the open market at the time of acquisition.

(3) Where this paragraph applies, the amounts brought into account for the purposes of this Chapter in the loss period shall be such as to secure that only so much of the loss as does not exceed 5 per cent. of the debt is treated for the purposes of this Chapter as arising in the loss period; but sub-paragraph (4) below applies as respects further parts of that loss until the loss is exhausted.

(4) A part of the loss may, in accordance with sub-paragraph (5) below, be brought into account for the purposes of this Chapter in the form of a debit for any accounting period after the loss period ("a subsequent period").

(5) The amount of the debit brought into account under sub-paragraph (4) above for any subsequent period shall not exceed such amount as, together with any parts of the loss which for earlier periods have been represented by-

(a) the amount of the loss treated as arising in the loss period in accordance with sub-paragraph (3) above, or

(b) debits brought into account in accordance with this sub-paragraph,

is equal to 5 per cent. of the debt for each complete year that has elapsed between the beginning of the loss period and the end of the subsequent period.

(6) In this paragraph "overseas State authority" and "relevant overseas debt" have the same meanings as in paragraph 8 above.

(7) References in this paragraph to a loss do not include so much of any loss as falls to be disregarded for the purposes of this Chapter by virtue of paragraph 10 below or to any loss incurred before 1st April 1996.

12.9.27.10.FA 1996 Sch.9 para.10

Imported losses etc.

(1) This paragraph applies in the case of a company ("the chargeable company") for an accounting period ("the loss period") where-

(a) an authorised accruals basis of accounting is used as respects a loan relationship of that company for the loss period;

(b) in accordance with that basis of accounting there is an amount which would fall (apart from this paragraph) to be brought into account for the purposes of this Chapter in respect of that relationship;

(c) by the bringing into account of that amount in that period a loss incurred in connection with that loan relationship would be treated for the purposes of this Chapter as arising in that period; and

(d) that loss is referable in whole or in part to a time when the relationship was not subject to United Kingdom taxation.

The amounts brought into account for the purposes of this Chapter in the loss period shall be such as to secure that no part of the loss that is referable to a time when the relationship was not subject to United Kingdom taxation shall be treated for the purposes of this Chapter as arising in the loss period or any other accounting period of the chargeable company.

(3) For the purposes of this paragraph a loss is referable to a time when a relationship is not subject to United Kingdom taxation to the extent that, at the time to which the loss is referable, the chargeable company would not have been chargeable to tax in the United Kingdom on any profits or gains arising from the relationship.

(4) Sub-paragraph (3) above shall have effect where the chargeable company was not a party to the relationship at the time to which the loss is referable as if the reference to that company were a reference to the person who at that time was in the same position as respects the relationship as is subsequently held by the chargeable company.

12.9.27.11.FA 1996 Sch.9 para.11

Transactions not at arm's length

(1) Subject to sub-paragraphs (2) and (3) below, where-

(a) debits or credits in respect of a loan relationship of a company fall to be brought into account for the purposes of this Chapter in accordance with an authorised accounting method,

(b) those debits or credits relate to amounts arising from, or incurred for the purposes of, a related transaction, and

(c) that transaction is not a transaction at arm's length,

the debits or credits given by that method shall be determined on the assumption that the transaction was entered into on the terms on which it would have been entered into between independent persons.

(2) Sub-paragraph (1) above shall not apply to debits arising from the acquisition of rights under a loan relationship where those rights are acquired for less than market value.

(3) Sub-paragraph (1) above does not apply-

(a) in the case of any related transaction between two companies that are members of the same group; or

(b) in relation to a member of a group of companies, in the case of any transaction which is part of a series of transactions having the same effect as a related transaction between two members of the same group.

In this paragraph "related transaction" has the same meaning as in section 84 of this Act.

(5) Section 170 of the Taxation of Chargeable Gains Act 1992 (groups etc.) shall apply for the interpretation of this paragraph as it applies for the interpretation of sections 171 to 181 of that Act.

12.9.27.12.FA 1996 Sch.9 para.12

Continuity of treatment: groups etc.

(1) Subject to paragraph 15 below, this paragraph applies where, as a result of-

(a) a related transaction between two members of the same group of companies,

(b) a series of transactions having the same effect as a related transaction between two companies each of which has been a member of the same group at any time in the course of that series of transactions,

(c) the transfer between two companies of the whole or part of the long term business of any insurance company in accordance with a scheme sanctioned by a court under Part I of Schedule 2C to the Insurance Companies Act 1982, or

(d) any transfer between two companies which is a qualifying overseas transfer within the meaning of paragraph 4A of Schedule 19AC to the Taxes Act 1988 (transfer of business of overseas life insurance company),

one of those companies ("the transferee company") directly or indirectly replaces the other ("the transferor company") as a party to a loan relationship.

(2) The credits and debits to be brought into account for the purposes of this Chapter in the case of the two companies shall be determined as follows-

(a) the transaction, or series of transactions, by virtue of which the replacement takes place shall be disregarded except for the purpose of identifying the company in whose case any debit or credit not relating to that transaction, or those transactions, is to be brought into account; and

(b) the transferor company and the transferee company shall be deemed (except for that purpose) to be the same company.

(3) This paragraph does not apply by virtue of sub-paragraph (1)(a) or (b) above in relation to any transfer of an asset, or of any rights under or interest in an asset, where the asset was within one of the categories set out in section 440(4)(a) to (e) of the Taxes Act 1988 (assets held for certain categories of long term business) either immediately before the transfer or immediately afterwards.

(4) This paragraph does not apply by virtue of sub-paragraph (1)(c) or (d) above in relation to any transfer of an asset, or of any rights under or interest in an asset, where-

(a) the asset was within one of the categories set out in section 440(4) of the Taxes Act 1988 immediately before the transfer; and

(b) is not within that category immediately afterwards.

(5) For the purposes of sub-paragraph (4) above, where one of the companies is an overseas life insurance company an asset shall be taken to be within the same category both immediately before the transfer and immediately afterwards if it-

(a) was within one category immediately before the transfer; and

(b) is within the corresponding category immediately afterwards.

(6) References in this paragraph to one company replacing another as a party to a loan relationship shall include references to a company becoming a party to any loan relationship under which its rights are equivalent to those of the other company under a loan relationship of which that other company has previously ceased to be a party.

(7) For the purposes of sub-paragraph (6) above a person's rights under a loan relationship are equivalent to rights under another such relationship if they entitle the holder of an asset representing the relationship-

(a) to the same rights against the same persons as to capital, interest and dividends, and

(b) to the same remedies for the enforcement of those rights,

notwithstanding any difference in the total nominal amounts of the assets, in the form in which they are held or in the manner in which they can be transferred.

(8) Sub-paragraphs (4) and (5) of paragraph 11 above have effect for the purposes of this paragraph as they have effect for the purposes of that paragraph.

(9) In this paragraph "overseas life insurance company" has the same meaning as in Chapter I of Part XII of the Taxes Act 1988.

12.9.27.13.FA 1996 Sch.9 para.13

Loan relationships for unallowable purposes

(1) Where in any accounting period a loan relationship of a company has an unallowable purpose, the debits which, for that period fall, in the case of that company, to be brought into account for the purposes of this Chapter shall not include so much of the debits given by the authorised accounting method used as respects that relationship as, on a just and reasonable apportionment, is attributable to the unallowable purpose.

(2) For the purposes of this paragraph a loan relationship of a company shall be taken to have an unallowable purpose in an accounting period where the purposes for which, at times during that period, the company-

(a) is a party to the relationship, or

(b) enters into transactions which are related transactions by reference to that relationship,

include a purpose ("the unallowable purpose") which is not amongst the business or other commercial purposes of the company.

(3) For the purposes of this paragraph the business and other commercial purposes of a company do not include the purposes of any part of its activities in respect of which it is not within the charge to corporation tax.

(4) For the purposes of this paragraph, where one of the purposes for which a company-

(a) is a party to a loan relationship at any time, or

(b) enters into a transaction which is a related transaction by reference to any loan relationship of the company,

is a tax avoidance purpose, that purpose shall be taken to be a business or other commercial purpose of the company only where it is not the main purpose, or one of the main purposes, for which the company is a party to the relationship at that time or, as the case may be, for which the company enters into that transaction.

(5) The reference in sub-paragraph (4) above to a tax avoidance purpose is a reference to any purpose that consists in securing a tax advantage (whether for the company or any other person).

(6) In this paragraph-

"related transaction" has the same meaning as in section 84 of this Act; and

"tax advantage" has the same meaning as in Chapter I of Part XVII of the Taxes Act 1988 (tax avoidance).

12.9.27.14.FA 1996 Sch.9 para.14

Debits and credits treated as relating to capital expenditure

This paragraph applies where any debit or credit given by an authorised accounting method for any accounting period in respect of a loan relationship of a company is allowed by normal accountancy practice to be treated, in the accounts of the company, as an amount brought into account in determining the value of a fixed capital asset or project.

(2) Notwithstanding the application to it of the treatment allowed by normal accountancy practice, the debit or credit shall be brought into account for the purposes of corporation tax, for the accounting period for which it is given, in the same way as

a debit or credit which, in accordance with normal accountancy practice, is brought into account in determining the company's profit or loss for that period.

12.9.27.15.FA 1996 Sch.9 para.15

Repo transactions and stock-lending

(1) In determining the debits and credits to be brought into account for the purposes of this Chapter in respect of any loan relationship, it shall be assumed that a disposal or acquisition to which this paragraph applies is not a related transaction for the purposes of section 84 of this Act.

(2) This paragraph applies to any such disposal or acquisition of rights or liabilities under the relationship as is made in pursuance of any repo or stock-lending arrangements.

(3) In this paragraph "repo or stock-lending arrangements" means any arrangements consisting in or involving an agreement or series of agreements under which provision is made-

(a) for the transfer from one person to another of any rights under that relationship; and

(b) for the transferor, or a person connected with him, subsequently to be or become entitled, or required-

(i) to have the same or equivalent rights transferred to him; or

(ii) to have rights in respect of benefits accruing in respect of that relationship on redemption.

(4) For the purposes of sub-paragraph (3) above rights under a loan relationship are equivalent to rights under another such relationship if they entitle the holder of an asset representing the relationship-

(a) to the same rights against the same persons as to capital, interest and dividends, and

(b) to the same remedies for the enforcement of those rights,

notwithstanding any difference in the total nominal amounts of the assets, in the form in which they are held or in the manner in which they can be transferred.

(5) Nothing in this paragraph shall prevent any redemption or discharge of rights or liabilities under a loan relationship to which any repo or stock-lending arrangements relate from being treated for the purposes of this Chapter as a related transaction (within the meaning of section 84 of this Act).

(6) This paragraph is without prejudice to section 730A(2) and (6) of the Taxes Act 1988 (deemed payments of loan interest in the case of the sale and re-purchase of securities).

(7) Section 839 of the Taxes Act 1988 (connected persons) applies for the purposes of this paragraph.

12.9.27.16.FA 1996 Sch.9 para.16

Imputed interest

This paragraph applies where, in pursuance of sections 770 to 772 of the Taxes Act 1988 (transactions at an undervalue or overvalue), as those sections have effect by virtue of section 773(4) of that Act, any amount falls to be treated as interest payable under a loan relationship of a company.

(2) Those sections shall have effect, notwithstanding the provisions of any authorised accounting method, so as to require credits or debits relating to the deemed interest to be brought into account for the purposes of this Chapter to the same extent as they would be in the case of an actual amount of interest accruing or becoming due and payable under the loan relationship in question.

12.9.27.17.FA 1996 Sch.9 para.17

Discounted securities where companies have a connection

(1) This paragraph applies as respects any accounting period ("the relevant period") where-

(a) a debtor relationship of a company ("the issuing company") is represented by a relevant discounted security issued by that company;

(b) the benefit of that security is available to another company at any time in that period;

(c) for that period there is a connection between the issuing company and the other company; and

(d) credits representing the full amount of the discount that is referable to that period are not for any accounting period brought into account for the purposes of this Chapter in respect of the corresponding creditor relationship.

(2) The debits falling in the case of the issuing company to be brought into account for the purposes of this Chapter in respect of the loan relationship shall be adjusted so that every debit relating to the amount of the discount that is referable to the relevant period is brought into account for the accounting period in which the security is redeemed, instead of for the relevant period.

(3) References in this paragraph to the amount of the discount that is referable to the relevant period are references to the amount relating to the difference between-

(a) the issue price of the security, and

(b) the amount payable on redemption,

which (apart from this paragraph) would for the relevant period be brought into account for the purposes of this Chapter in the case of the issuing company.

(4) In this paragraph "relevant discounted security" has the same meaning as in Schedule 13 to this Act; and the provisions of that Schedule shall apply for the purposes of this paragraph for determining the difference between the issue price of a security and the amount payable on redemption as they apply for the purposes of paragraph 3(3) of that Schedule.

(5) For the purposes of this paragraph there is a connection between one company and another for the relevant period if (subject to the following provisions of this paragraph)-

(a) there is a time in that period, or in the period of two years before the beginning of that period, when one of the companies has had control of the other; or

(b) there is a time in that period, or in those two years, when both the companies have been under the control of the same person.

(6) Two companies which have at any time been under the control of the same person shall not, by virtue of that fact, be taken for the purposes of this paragraph to be companies between whom there is a connection if the person was the Crown, a Minister of the Crown, a government department, a Northern Ireland department, a foreign sovereign power or an international organisation.

(7) Section 88 of this Act shall apply for the purposes of this paragraph in the case of a debtor relationship of a company represented by a relevant discounted security as it would apply for the purposes of section 87 of this Act in the case of the corresponding creditor relationship of the company holding that security and, accordingly, as if-

(a) the reference to section 87 of this Act in section 88(4)(b) were a reference to this paragraph; and

(b) section 88(5) were omitted.

(8) For the purposes of this paragraph the benefit of a security is available to a company if-

(a) that security, or any entitlement to rights attached to it, is beneficially owned by that company; or

(b) that company is indirectly entitled, by reference to a series of loan transactions, to the benefit of any rights attached to the security.

(9) Subsections (2) to (6) of section 416 of the Taxes Act 1988 (meaning of "control") shall apply for the purposes of this paragraph as they apply for the purposes of Part XI of that Act.

12.9.27.18.FA 1996 Sch.9 para.18

Discounted securities of close companies

(1) This paragraph applies for any accounting period where-

(a) a debtor relationship of a close company is represented by a relevant discounted security issued by the company; and

(b) at any time in or before that period that security has been beneficially owned by a person who at the time was-

(i) a participator in the company;

(ii) an associate of such a participator; or

(iii) a company of which such a participator has control.

(2) The debits falling in the case of the company to be brought into account for the purposes of this Chapter in respect of the loan relationship shall be adjusted so that no amount is brought into account in respect of the difference between-

(a) the issue price of the security, and

(b) the amount payable on redemption,

for any accounting period before that in which the security is redeemed.

(3) In this paragraph "relevant discounted security" has the same meaning as in Schedule 13 to this Act; and the provisions of that Schedule shall apply for the purposes of this paragraph for determining the difference between the issue price of a security and the amount payable on redemption as they apply for the purposes of paragraph 3(3) of that Schedule.

(4) In this paragraph-

"associate" has the meaning given in section 417(3) and (4) of the Taxes Act 1988;

"control" shall be construed in accordance with section 416(2) to (6) of that Act; and

"participator" means a person who, by virtue of section 417 of that Act, is a participator in the company for the purposes of Part XI of that Act, other than a person who is a participator for those purposes by virtue only of his holding a relevant discounted security issued by the company.

(5) In determining whether a person who carries on a business of banking is a participator in a company for the purposes of this paragraph, there shall be disregarded any securities of the company acquired by him in the ordinary course of his business.

12.9.28. FA 1996 SCHEDULE 12

Meaning of debt contract or option

The section inserted after section 150 of the Finance Act 1994 by section 101(3) of this Act is as follows-

"Debt contracts and options.

150A. - (1) A contract is a debt contract for the purposes of this Chapter if, not being an interest rate contract or option or a currency contract or option-

(a) it is a contract under which, whether unconditionally or subject to conditions being fulfilled, a qualifying company has any entitlement, or is subject to any duty, to become a party to a loan relationship; and

(b) the only transfers of money or money's worth for which the contract provides (apart from those that will be made under the loan relationship) are payments falling within subsection (5) below and payments falling within section 151 below.

(2) A contract is also a debt contract for the purposes of this Chapter if, not being a debt contract by virtue of subsection (1) above or an interest rate contract or option or a currency contract or option-

(a) it is a contract under which, whether unconditionally or subject to conditions being fulfilled, a qualifying company has any entitlement, or is subject to any duty, to become treated as a person with rights and liabilities corresponding to those of a party to a loan relationship; and

(b) the only transfers of money or money's worth for which the contract provides are payments falling within subsection (6) below and payments falling within section 151 below.

(3) In this section references to an entitlement to become a party to a loan relationship, or to a duty to become such a party, shall be taken to include references, in relation to a specified loan relationship, to either of the following, namely-

(a) an entitlement or, as the case may be, a duty to become a party to an equivalent relationship; and

(b) an entitlement or, as the case may be, a duty relating to the making of any one or more such payments as fall within subsection (5) below.

(4) Subsection (3) above shall apply in relation to references in this section to an entitlement or a duty to become treated as a person with rights and liabilities corresponding to those of a party to a loan relationship as it applies to references to an entitlement or, as the case may be, a duty to become such a party.

(5) The payments falling within this subsection are-

(a) a payment of an amount representing the price for becoming a party to the relationship;

(b) a payment of an amount determined by reference to the value at any time of the money debt by reference to which the relationship subsists;

(c) a settlement payment of an amount determined by reference to the difference at specified times between-

(i) the price for becoming a party to the relationship; and

(ii) the value of the money debt by reference to which the relationship subsists, or (if the relationship were in existence) would subsist.

(6) A payment falls within this subsection if it is a settlement payment of an amount determined by reference to the difference at specified times between-

(a) the price for becoming treated as a person with rights and liabilities corresponding to those of a party to a relationship; and

(b) the value of the money debt by reference to which the relationship subsists or (if the relationship existed) would subsist.

(7) Each of the following, namely-

(a) an option to enter into a contract which would be a debt contract, and

(b) an option to enter into such an option,

is a debt option for the purposes of this Chapter if the only transfers of money or money's worth for which the option provides are payments falling within section 151 below.

(8) For the purposes of this Chapter where any contract contains both-

(a) provisions under which, whether unconditionally or subject to conditions being fulfilled, a qualifying company has any entitlement, or is subject to any duty, to become a party to a loan relationship, and

(b) any provisions that have effect otherwise than for the purposes of or in relation to the provisions conferring that entitlement or imposing that duty,

the provisions mentioned in paragraph (a) above, together with the other contents of that contract so far as they are attributable on a just and reasonable basis to the provisions mentioned in that paragraph, shall be treated as a separate contract.

(9) For the purposes of this Chapter where-

(a) any attribution of the contents of a contract falls to be made between provisions falling within paragraph (a) of subsection (8) above and provisions falling within paragraph (b) of that subsection, and

(b) that contract provides for the making of any payment constituting a transfer of money or money's worth which cannot be attributed to the provisions falling within only one of those paragraphs,

that payment shall be treated as apportioned between the provisions falling within each of those paragraphs in such manner as may be just and reasonable.

(10) Expressions used in this section and in Chapter II of Part IV of the Finance Act 1996 have the same meanings in this section as in that Chapter; but references in this section to a loan relationship do not include-

(a) any loan relationship represented by an asset to which section 92 of that Act (convertible securities) applies; or

(b) any loan relationship to which section 93 of that Act (securities indexed to chargeable assets) applies.

(11) For the purposes of this section and, so far as it relates to a debt contract or option, of section 151 below the transfer of money's worth having a value of any amount shall be treated as the payment of that amount."

12.9.29. SCHEDULE 13

Discounted securities: income tax provisions

12.9.29.1.FA 1996 Sch.13 para.1

Charge to tax on realised profit comprised in discount

(1) Where a person realises the profit from the discount on a relevant discounted security, he shall be charged to income tax on that profit under Case III of Schedule D or, where the profit arises from a security out of the United Kingdom, under Case IV of that Schedule.

(2) For the purposes of this Schedule a person realises the profit from the discount on a relevant discounted security where-

(a) he transfers such a security or becomes entitled, as the person holding the security, to any payment on its redemption; and

(b) the amount payable on the transfer or redemption exceeds the amount paid by that person in respect of his acquisition of the security.

(3) For the purposes of this Schedule the profit shall be taken-

(a) to be equal to the amount of the excess reduced by the amount of any relevant costs; and

(b) to arise, for the purposes of income tax, in the year of assessment in which the transfer or redemption takes place.

(4) In this paragraph "relevant costs", in relation to a security that is transferred or redeemed, are all the following costs-

(a) the costs incurred in connection with the acquisition of the security by the person making the transfer or, as the case may be, the person entitled to a payment on the redemption; and

(b) the costs incurred by that person in connection with the transfer or redemption of the security;

and for the purposes of this Schedule costs falling within paragraph (a) above shall not be regarded as amounts paid in respect of the acquisition of a security.

12.9.29.2.FA 1996 Sch.13 para.2

Realised losses on discounted securities

(1) Subject to the following provisions of this Schedule, where-

(a) a person sustains a loss in any year of assessment from the discount on a relevant discounted security, and

(b) makes a claim for the purposes of this paragraph before the end of twelve months from the 31st January next following that year of assessment,

that person shall be entitled to relief from income tax on an amount of the claimant's income for that year equal to the amount of the loss.

(2) For the purposes of this Schedule a person sustains a loss from the discount on a relevant discounted security where-

(a) he transfers such a security or becomes entitled, as the person holding the security, to any payment on its redemption; and

(b) the amount paid by that person in respect of his acquisition of the security exceeds the amount payable on the transfer or redemption.

(3) For the purposes of this Schedule the loss shall be taken-

(a) to be equal to the amount of the excess increased by the amount of any relevant costs; and

(b) to be sustained for the purposes of this Schedule in the year of assessment in which the transfer or redemption takes place.

Sub-paragraph (4) of paragraph 1 above applies for the purposes of this paragraph as it applies for the purposes of that paragraph.

12.9.29.3.FA 1996 Sch.13 para.3

Meaning of "relevant discounted security"

(1) Subject to sub-paragraph (2) and paragraph 14(1) below, in this Schedule "relevant discounted security" means any security which (whenever issued) is such that-

(a) taking the security as at the time of its issue, and

(b) assuming redemption in accordance with its terms,

the amount payable on redemption is an amount involving a deep gain or might be an amount which would involve such a gain.

(2) The following are not relevant discounted securities for the purposes of this Schedule-

(a) shares in a company;

(b) gilt-edged securities that are not strips;

(c) excluded indexed securities;

(d) life assurance policies;

(e) capital redemption policies (within the meaning of Chapter II of Part XIII of the Taxes Act 1988); and

(f) subject to paragraph 10 below, securities issued (at whatever time) under the same prospectus as other securities which have been issued previously but (disregarding that paragraph) are not themselves relevant discounted securities.

(3) For the purposes of this Schedule the amount payable on redemption of a security involves a deep gain if-

(a) the issue price is less than the amount so payable; and

(b) the amount by which it is less represents more than the relevant percentage of the amount so payable.

(4) In this paragraph "the relevant percentage", in relation to the amount payable on redemption of a security, means-

(a) the percentage figure equal, in a case where the period between the date of issue and the date of redemption is less than thirty years, to one half of the number of years between those dates; and

(b) in any other case, 15 per cent.;

and for the purposes of this paragraph the fraction of a year to be used for the purposes of paragraph (a) above in a case where the period mentioned in that paragraph is not a number of complete years shall be calculated by treating each complete month, and any remaining part of a month, in that period as one twelfth of a year.

(5) References in this paragraph to redemption-

(a) do not include references to any redemption which may be made before maturity otherwise than at the option of the holder of the security; but

(b) in the case of a security that is capable of redemption at the option of the holder before maturity, shall have effect as references to the earliest occasion on which the holder of the security may require the security to be redeemed.

For the purposes of this paragraph the amount payable on redemption shall not be taken to include any amount payable on that occasion by way of interest.

12.9.29.4.FA 1996 Sch.13 para.4

Meaning of "transfer"

(1) Subject to sub-paragraph (2) below, in this Schedule references to a transfer, in relation to a security, are references to any transfer of the security by way of sale, exchange, gift or otherwise.

(2) Where an individual who is entitled to a relevant discounted security dies, then for the purposes of this Schedule-

(a) he shall be treated as making a transfer of the security immediately before his death;

(b) he shall be treated as obtaining in respect of the transfer an amount equal to the market value of the security at the time of the transfer; and

(c) his personal representatives shall be treated as acquiring the security for that amount on his death.

For the purposes of this Schedule a transfer or acquisition of a security made in pursuance of an agreement shall be deemed to take place at the time when the agreement is made, if the person to whom the transfer is made, or who makes the acquisition, becomes entitled to the security at that time.

(4) If an agreement is conditional, whether on the exercise of an option or otherwise, it shall be taken for the purposes of this paragraph to be made when the condition is satisfied (whether by the exercise of the option or otherwise).

(5) This paragraph is without prejudice to paragraph 14(2) to (4) below.

12.9.29.5.FA 1996 Sch.13 para.5

Redemption to include conversion

(1) This paragraph applies where a relevant discounted security is extinguished by being converted, in pursuance of rights conferred by the security, into shares in a company or into any other securities (including other relevant discounted securities).

(2) For the purposes of this Schedule the conversion shall be deemed-

(a) to constitute the redemption of the security which is extinguished; and

(b) to involve a payment on redemption of an amount equal to whatever, at the time of the conversion, is the market value of the shares or other securities into which the security in question is converted.

This paragraph does not apply to an exchange to which paragraph 14 below applies.

12.9.29.6.FA 1996 Sch.13 para.6

Trustees and personal representatives

(1) Where, on a transfer or redemption of a security by trustees, an amount is treated as income chargeable to tax by virtue of this Schedule-

(a) that amount shall be taken for the purposes of Chapters IA and IB of Part XV of the Taxes Act 1988 (settlements: liability of settlor etc.) to be income arising-

(i) under the settlement of which the trustees are trustees; and

(ii) from that security;

(b) that amount shall be taken for the purposes of Chapter IC of Part XV of that Act (settlements: liability of trustees) to be income arising to the trustees; and

(c) to the extent that tax on that amount is charged on the trustees, the rate at which it is chargeable shall be taken (where it would not otherwise be the case) to be the rate applicable to trusts for the year of assessment in which the transfer or redemption is made.

(2) Where the trustees are trustees of a scheme to which section 469 of the Taxes Act 1988 (unauthorised unit trusts) applies, sub-paragraph (1) above shall not apply if or to the extent that the amount is treated as income in the accounts of the scheme.

(3) Without prejudice to paragraph 12 below, paragraphs 1(1) and 2(1) above do not apply in the case of-

(a) any transfer of a security for the time being held under a settlement the trustees of which are not resident in the United Kingdom; or

(b) any redemption of a security which is so held immediately before its redemption.

(4) Relief shall not be given to trustees under paragraph 2 above except from income tax on income chargeable under paragraph 1 above.

(5) Sub-paragraph (6) below applies where, in the case of any trustees, the amount mentioned in paragraph (a) below exceeds in any year of assessment the amount mentioned in paragraph (b) below, that is to say-

(a) the aggregate amount of the losses in respect of which relief from income tax may be given to the trustees for that year under paragraph 2 above (including any amount treated as such a loss by virtue of that sub-paragraph); and

(b) the income of those trustees chargeable for that year to tax under paragraph 1 above.

(6) Subject to paragraph 7(2) below, the excess shall for the purposes of this Schedule be-

(a) carried forward to the immediately following year of assessment; and

(b) in relation to the year to which it is carried forward, treated as if it were a loss sustained in that year by the trustees from a discount on a relevant discounted security.

Where a relevant discounted security is transferred by personal representatives to a legatee, they shall be treated for the purposes of this Schedule as obtaining in respect of the transfer an amount equal to the market value of the security at the time of the transfer.

(8) In this paragraph "legatee" includes any person taking (whether beneficially or as trustee) under a testamentary disposition or on an intestacy or partial intestacy, including any person taking by virtue of an appropriation by the personal representatives in or towards satisfaction of a legacy or other interest or share in the deceased's property.

12.9.29.7.FA 1996 Sch.13 para.7

Treatment of losses where income exempt

(1) Where-

(a) on the transfer or redemption of any relevant discounted security, a loss is sustained from the discount on that security, and

(b) if the person sustaining that loss had realised a profit from that discount on that transfer or redemption, the profit would have been an exempt profit for the year of assessment in which the loss is sustained,

relief shall not be given to that person under paragraph 2 above in respect of that loss except from income tax on income chargeable for that year under paragraph 1 above.

(2) No part of any loss to which sub-paragraph (1) above applies shall be carried forward under paragraph 6(6) above.

(3) The reference in sub-paragraph (1) above to an exempt profit for a year of assessment is a reference to any income for that year which-

(a) is eligible for relief from tax by virtue of section 505(1) of the Taxes Act 1988, or would be so eligible but for section 505(3) of that Act (charities); or

(b) is eligible for relief from tax by virtue of section 592(2), 608(2)(a), 613(4), 614(2), (3), (4) or (5), 620(6) or 643(2) of that Act (pension scheme funds etc.).

(4) Where a loss to which sub-paragraph (1) above applies is sustained in a case in which the profit mentioned in paragraph (b) of that sub-paragraph would be eligible for relief under section 592(2) of the Taxes Act 1988-

(a) relief shall be given under paragraph 2 above in accordance with sub-paragraph (1) above before any computation is made under paragraph 7 of Schedule 22 to that Act, and

(b) that paragraph 7 shall have effect, accordingly, so that the amount of income to which the specified percentage is applied by virtue of sub-paragraph (3)(a) of that paragraph is reduced by the amount of the relief.

12.9.29.8.FA 1996 Sch.13 para.8

Transfers between connected persons

(1) This paragraph applies where a relevant discounted security is transferred from one person to another and they are connected with each other.

(2) For the purposes of this Schedule-

(a) the person making the transfer shall be treated as obtaining in respect of it an amount equal to the market value of the security at the time of the transfer; and

(b) the person to whom the transfer is made shall be treated as paying in respect of his acquisition of the security an amount equal to that market value.

Section 839 of the Taxes Act 1988 (connected persons) shall apply for the purposes of this paragraph.

12.9.29.9.FA 1996 Sch.13 para.9

Other transactions deemed to be at market value

(1) This paragraph applies where a relevant discounted security is transferred from one person to another in a case in which-

(a) the transfer is made for a consideration which consists of or includes consideration not in money or money's worth; or

(b) the transfer is made otherwise than by way of a bargain made at arm's length.

(2) For the purposes of this Schedule-

(a) the person making the transfer shall be treated as obtaining in respect of it an amount equal to the market value of the security at the time of the transfer, and

(b) the person to whom the transfer is made shall be treated as paying in respect of his acquisition of the security an amount equal to that market value.

12.9.29.10.FA 1996 Sch.13 para.10

Issue of securities in separate tranches

(1) In a case where-

(a) none of the securities issued on the occasion of the original issue of securities under a particular prospectus would be a relevant discounted security apart from this paragraph,

(b) some of the securities subsequently issued under the prospectus would be relevant discounted securities apart from paragraph 3(2)(f) above, and

(c) there is a time (whether before, at or after the beginning of the year 1996-97) when the aggregate nominal value as at that time of the securities falling within paragraph (b) above exceeds the aggregate nominal value as at that time of the securities which have been issued under the prospectus and do not fall within that paragraph,

sub-paragraph (2) below shall apply in relation to every security which has been or is issued under the prospectus at any time (whether before, at or after the time mentioned in paragraph (c) above).

(2) As regards any event occurring in relation to the security after the time mentioned in sub-paragraph (1)(c) above, this Schedule shall have effect as if the security-

(a) were a relevant discounted security; and

(b) had been acquired as such (whatever the time of its acquisition).

For the purposes of sub-paragraph (2) above events, in relation to a security, include anything constituting a transfer, redemption or acquisition for the purposes of this Schedule.

12.9.29.11.FA 1996 Sch.13 para.11

Accrued income scheme

In a case where-

(a) paragraph 1 or 2 above applies on the transfer of any security, and

(b) apart from this paragraph, the transfer would be a transfer for the purposes of sections 710 to 728 of the Taxes Act 1988,

the transfer shall be treated as if it were not a transfer for those purposes.

12.9.29.12.FA 1996 Sch.13 para.12

Assets transferred abroad

For the purposes of sections 739 and 740 of the Taxes Act 1988 (prevention of avoidance of tax by transfer of assets abroad), where a person resident or domiciled outside the United Kingdom realises a profit from the discount on a relevant discounted security, that profit shall be taken to be income of that person.

12.9.29.13.FA 1996 Sch.13 para.13

Excluded indexed securities

(1) For the purposes of this Schedule a security is an excluded indexed security if the amount payable on redemption is linked to the value of chargeable assets.

(2) For the purposes of this paragraph an amount is linked to the value of chargeable assets if, in pursuance of any provision having effect for the purposes of the security, it is equal to an amount determined by applying a relevant percentage change in the value of chargeable assets to the amount for which the security was issued.

(3) In sub-paragraph (2) above the reference to a relevant percentage change in the value of chargeable assets is a reference to the amount of the percentage change (if any) over the relevant period in the value of chargeable assets of any particular description or in any index of the value of any such assets.

(4) In sub-paragraph (3) above "the relevant period" means-

(a) the period between the time of the issue of the security and its redemption; or

(b) any other period in which almost all of that period is comprised and which differs from that period exclusively for purposes connected with giving effect to a valuation in relation to rights or liabilities under the security.

(5) If-

(a) there is a provision which, in the case of the amount payable on the redemption of any security, falls within sub-paragraph (2) above,

(b) that provision is made subject to any other provision applying to the determination of that amount,

(c) that other provision is to the effect only that that amount must not be less than a specified percentage of the amount for which the security is issued, and

(d) the specified percentage is not more than 10 per cent.,

that other provision shall be disregarded in determining for the purposes of this paragraph whether the amount payable on redemption is linked to the value of chargeable assets.

(6) For the purposes of this paragraph an asset is a chargeable asset in relation to any security if any gain accruing to a person on a disposal of that asset would, on the assumptions specified in sub-paragraph (7) below, be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act 1992.

(7) Those assumptions are-

(a) where it is not otherwise the case, that the asset is an asset of the person in question and that that person does not have the benefit of any exemption conferred by section 100 of that Act of 1992 (exemption for authorised unit trusts etc.);

(b) that the asset is not one the disposal of which by that person would fall to be treated for the purposes of income tax as a disposal in the course of a trade, profession or vocation carried on by that person; and

(c) that chargeable gains that might accrue under section 116(10) of that Act are to be disregarded.

(8) For the purposes of this paragraph neither-

(a) the retail prices index, nor

(b) any similar general index of prices published by the government of any territory or by the agent of any such government,

shall be taken to be an index of the value of chargeable assets.

12.9.29.14.FA 1996 Sch.13 para.14

Gilt strips

(1) Every strip is a relevant discounted security for the purposes of this Schedule.

(2) For the purposes of this Schedule, where a person exchanges a gilt-edged security for strips of that security, the person who receives the strips in the exchange shall be deemed to have paid, in respect of his acquisition of each strip, the amount which bears the same proportion to the market value of the security as is borne by the market value of the strip to the aggregate of the market values of all the strips received in exchange for the security.

(3) For the purposes of this Schedule, where strips are consolidated into a single gilt-edged security by being exchanged by any person for that security, each of the strips shall be deemed to have been redeemed at the time of the exchange by the payment to that person of the amount equal to its market value.

(4) A person who holds a strip on the 5th April in any year of assessment, and who (apart from this sub-paragraph) does not transfer or redeem it on that day, shall be deemed for the purposes of this Schedule-

(a) to have transferred that strip on that day;

(b) to have received in respect of that transfer an amount equal to the strip's market value on that day; and

(c) to have re-acquired the strip on the next day on payment of an amount equal to the amount for which it is deemed to have been disposed of on the previous day;

and the deemed transfer and re-acquisition shall be assumed for the purposes of paragraphs 1 and 2 above to be transactions in connection with which no relevant costs are incurred.

(5) Without prejudice to the generality of any power conferred by section 202 of this Act, the Treasury may by regulations provide that this Schedule is to have effect with such modifications as they may think fit in relation to any relevant discounted security which is a strip.

(6) Regulations made by the Treasury under this paragraph may-

(a) make provision for the purposes of sub-paragraphs (2) to (4) above as to the manner of determining the market value at any time of any security;

(b) make different provision for different cases; and

(c) contain such incidental, supplemental, consequential and transitional provision as the Treasury may think fit.

References in sub-paragraphs (2) and (3) above to the market value of a security given or received in exchange for another are references to its market value at the time of the exchange.

12.9.29.15.FA 1996 Sch.13 para.15

General interpretation

(1) In this Schedule-

"deep gain" shall be construed in accordance with paragraph 3(3) above;

"excluded indexed security" has the meaning given by paragraph 13 above;

"market value" (except in paragraph 14 above) has the same meaning as in the Taxation of Chargeable Gains Act 1992;

"relevant discounted security" has the meaning given by paragraphs 3 and 14(1) above;

"strip" means anything which, within the meaning of section 47 of the Finance Act 1942, is a strip of a gilt-edged security.

(2) Where a person, having acquired and transferred any security, subsequently re-acquires it, references in this Schedule to his acquisition of the security shall have effect, in relation to-

(a) the transfer by him of that security, or

(b) the redemption of the security in a case where he becomes entitled to any amount on its redemption,

as references to his most recent acquisition of the security before the transfer or redemption in question.

12.9.29.16.FA 1996 Sch.13 para.16

Application of Schedule for income tax purposes only

(1) This Schedule does not apply for the purposes of corporation tax.

(2) Sub-paragraph (1) above is without prejudice to any enactment not contained in this Schedule by virtue of which the definition of a relevant discounted security, or any other provision of this Schedule, is applied for the purposes of corporation tax.

12.9.30.FA 1996 SCHEDULE 14

Loan relationships: minor and consequential amendments

12.9.30.1.FA 1996 Sch.14 para.14

ICTA 1988

In subsection (2)(b) of section 337 of that Act (deduction of yearly interest etc. in computing income), for "yearly interest, annuity or other annual payment" there shall be substituted "annuity or other annual payment which is not interest".

(2) Subsection (3) of that section (deduction of yearly interest payable to a bank) shall cease to have effect.

12.9.30.2.FA 1996 Sch.14 para.20

ICTA 1988

(1) In section 401 of that Act (relief for pre-trading expenditure), after subsection (1) there shall be inserted the following subsections-

"(1AA) Subsection (1) above shall not apply to any expenditure in relation to which any debit falls, or (but for subsection (1AB) below) would fall, to be brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships).

(1AB) Where, in the case of any company-

(a) a non-trading debit is given for any accounting period for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships), and

(b) an election for the purposes of this section is made by that company with respect to that debit within the period of 2 years beginning with the end of that accounting period,

that debit shall not be brought into account for the purposes of that Chapter as a non-trading debit for that period, but subsection

(1AC) below shall apply instead.

(1AC) If a company-

(a) begins to carry on a trade within the period of seven years after the end of the accounting period for which a non-trading debit is given for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships),

(b) that debit is such that, if it had been given for the accounting period in which the company begins to carry on that trade, it would have been brought into account by reference to that trade in accordance with section 82(2) of that Act (trading debits and credits), and

(c) an election is or has been made with respect to that debit under subsection (1AB) above,

that debit shall be treated for the purposes of that Chapter as if it were a debit for the accounting period in which the company begins to carry on the trade and shall be brought into account for that period in accordance with section 82(2) of that Act."

Subsection (1A) of that section shall cease to have effect.

12.9.30.3.FA 1996 Sch.14 para.37

ICTA 1988

In section 730A of that Act (treatment of price differential on repos) the following subsections shall be substituted for subsection (6)-

"(6) For the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships)-

(a) interest deemed by virtue of subsection (2) above to be paid or received by any company shall be deemed to be interest under a loan relationship; and

(b) the debits and credits falling to be brought into account for the purposes of that Chapter so far as they relate to the deemed interest shall be those given by the use in relation to the deemed interest of an authorised accruals basis of accounting.

(6A) Any question whether debits or credits brought into account in accordance with subsection (6) above in relation to any company-

(a) are to be brought into account under section 82(2) of the Finance Act 1996 (trading loan relationships), or

(b) are to be treated as non-trading debits or credits,

shall be determined (subject to Schedule 11 to that Act (insurance companies)) according to the extent (if any) to which the company is a party to the repurchase in the course of activities forming an integral part of a trade carried on by the company."

12.9.30.4.FA 1996 Sch.14 para.43

ICTA 1988

After section 797 of that Act there shall be inserted the following section-

"Foreign tax on interest brought into account as a non-trading credit.

797A. - (1) This section applies for the purposes of any arrangements where, in the case of any company-

(a) any non-trading credit relating to an amount of interest is brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) for any accounting period ("the applicable accounting period"); and

(b) there is in respect of that amount an amount of foreign tax for which, under the arrangements, credit is allowable against United Kingdom tax computed by reference to that interest.

(2) It shall be assumed that tax chargeable under paragraph (a) of Case III of Schedule D on the profits and gains arising for the applicable accounting period from the company's loan relationships falls to be computed on the actual amount of its non-trading credits for that period, and without any deduction in respect of non-trading debits.

(3) Section 797(3) shall have effect (subject to subsection (7) below) as if-

(a) there were for the applicable accounting period an amount equal to the adjusted amount of the non-trading debits falling to be brought into account by being set against profits of the company for that period of any description; and

(b) different parts of that amount might be set against different profits.

(4) For the purposes of this section, the adjusted amount of a company's non-trading debits for any accounting period is the amount equal, in the case of that company, to the aggregate of the non-trading debits given for that period for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) less the aggregate of the amounts specified in subsection (5) below.

(5) Those amounts are-

(a) so much of any non-trading deficit for the applicable accounting period as is an amount to which a claim under subsection (2)(b), (c) or (d) of section 83 of the Finance Act 1996 or paragraph 4(3) of Schedule 11 to that Act (group relief and transfer to previous or subsequent period of deficits) relates;

(b) so much of any non-trading deficit for that period as falls to be carried forward to a subsequent period in accordance with subsection (3) of that section or paragraph 4(4) of that Schedule; and

(c) any amount carried forward to the applicable accounting period in pursuance of a claim under section 83(2)(d) of that Act.

(6) Section 797(3) shall have effect as if any amount specified in subsection (5)(c) above were an amount capable of being allocated only to any non-trading profits of the company.

(7) Where-

(a) the company has a non-trading deficit for the applicable accounting period,

(b) the amount of that deficit exceeds the aggregate of the amounts specified in subsection (5) above, and

(c) in pursuance of a claim under-

(i) subsection (2)(a) of section 83 of the Finance Act 1996 (deficit set against current year profits), or

(ii) paragraph 4(2) of Schedule 11 to that Act (set-off of deficits in the case of insurance companies),

the excess falls to be set off against profits of any description,

section 797(3) shall have effect as if non-trading debits of the company which in aggregate are equal to the amount of the excess were required to be allocated to the profits against which they are set off in pursuance of the claim.

(8) In this section "non-trading profits" has the same meaning as in paragraph 4 of Schedule 8 to the Finance Act 1996."

12.9.30.5.FA 1996 Sch.14 para.44

ICTA 1988

(1) In section 798 of that Act (interest on certain overseas loans), after subsection (2) there shall be inserted the following subsection-

"(2A) For the purposes of corporation tax, this section shall apply only where the expenditure referred to in subsection (1)(b) above falls, in the case of the lender, to be brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) in accordance with section 82(2) of that Act (trading debits and credits)."

(2) After subsection (3) of that section (deemed increase of interest) there shall be inserted the following subsection-

"(3A) Subsection (3) above has effect for the purposes of corporation tax notwithstanding anything in section 80(5) of the Finance Act 1996 (matters to be brought into account in the case of loan relationships only under Chapter II of Part IV of that Act)."

12.9.30.6.FA 1996 Sch.14 para.46

ICTA 1988

After section 807 of that Act there shall be inserted the following section-

"Disposals and acquisitions of company loan relationships with or without interest.

807A. - (1) This Part shall have effect for the purposes of corporation tax in relation to any company as if tax falling within subsection (2) below were to be disregarded.

(2) Tax falls within this subsection in relation to a company to the extent that it is-

(a) tax under the law of a territory outside the United Kingdom; and

(b) is attributable, on a just and reasonable apportionment, to interest accruing under a loan relationship at a time when the company is not a party to the relationship.

(3) Subject to subsections (1), (4) and (5) of this section, where-

(a) any non-trading credit relating to an amount of interest under a loan relationship is brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) in the case of any company,

(b) that amount falls, as a result of any related transaction, to be paid to a person other than the company, and

(c) had the company been entitled, at the time of that transaction, to receive a payment of an amount of interest equal to the amount of interest to which the non-trading credit relates, the company would have been liable in respect of the amount of interest received to an amount of tax under the law of a territory outside the United Kingdom,

credit for that amount of tax shall be allowable under section 790(4) as if that amount of tax were an amount of tax paid under the law of that territory in respect of the amount of interest to which the non-trading credit relates.

(4) Subsection (3) above does not apply in the case of a credit brought into account in accordance with paragraph 1(2) of Schedule 11 to the Finance Act 1996 (the I minus E basis).

(5) The Treasury may by regulations provide for subsection (3) above to apply-

(a) in the case of trading credits, as well as in the case of non-trading credits;

(b) in the case of any credit ("an insurance credit") in the case of which, by virtue of subsection (4) above, it would not otherwise apply.

(6) Regulations under subsection (5) above may-

(a) provide for subsection (3) above to apply in the case of a trading credit or an insurance credit only if the circumstances are such as may be described in the regulations;

(b) provide for subsection (3) above to apply, in cases where it applies by virtue of any such regulations, subject to such exceptions, adaptations or other modifications as may be specified in the regulations;

(c) make different provision for different cases; and

(d) contain such incidental, supplemental, consequential and transitional provision as the Treasury think fit.

(7) In this section-

"related transaction" has the same meaning as in section 84 of the Finance Act 1996; and

"trading credit" means any credit falling to be brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) in accordance with section 82(2) of that Act."

12.9.30.7.FA 1996 Sch.14 para.66

ICTA 1988

(1) In section 254 of that Act (relief for debts on qualifying corporate bonds), in subsection (1)(c), after "bond" there shall be inserted "but is not a relevant discounted security for the purposes of Schedule 13 to the Finance Act 1996".

(2) After subsection (12) of that section there shall be inserted the following subsection-

"(13) This section does not apply for the purposes of corporation tax."

12.9.30.8.FA 1996 Sch.14 para.67

The Finance Act 1993

In section 127 of the Finance Act 1993 (accrual of amounts where debts vary), after subsection (1) there shall be inserted the following subsections-

"(1A) For the purposes of this section if, in the case of any debt-

(a) an amount in respect of any discount or premium relating to that debt is treated, on an accruals basis of accounting, as accruing at any time for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships), or

(b) any such amount would be treated as so accruing if the authorised method of accounting used for those purposes as respects the loan relationship relating to that debt were an accruals basis of accounting, instead of a mark to market basis,

then, for the purposes of this section, there shall be deemed to be such a variation at that time of the nominal amount of the debt outstanding as is specified in subsection (1B) below.

(1B) That variation is-

(a) if the amount mentioned in paragraph (a) or (b) of subsection (1A) above relates to a discount, a variation that increases the nominal amount of the debt outstanding by the amount so mentioned; and

(b) if the amount so mentioned relates to a premium, a variation that decreases the nominal amount of the debt outstanding by the amount so mentioned."

12.9.30.9.FA 1996 Sch.14 para.70

FA 1993

(1) For subsection (4) of section 153 of that Act (qualifying assets and liabilities) there shall be substituted the following subsection-

"(4) A right to settlement under a qualifying debt is not a qualifying asset where the company having the right holds an asset representing the debt and that asset is-

(a) an asset to which section 92 of the Finance Act 1996 applies (convertible securities); or

(b) an asset representing a loan relationship to which section 93 of that Act (relationships linked to the value of chargeable assets) applies."

Subsection (6) of that section shall cease to have effect.

12.9.31.FA 1996 SCHEDULE 15

Loan relationships: savings and transitional provisions part i corporation tax

12.9.31.1.FA 1996 Sch.15 para.23

Carrying back non-trading losses against exchange profits etc.

(1) Subject to sub-paragraph (2) below, for the purpose of setting any amount against exchange profits for an accounting period beginning before 1st April 1996-

(a) a claim may be made under section 131(5) or (6) of the Finance Act 1993 (treatment of exchange gains and losses) in relation to any relievable amount for an accounting period ending on or after 1st April 1996; and

(b) the provisions of sections 129 to 133 of that Act shall be deemed to have effect for the purposes of that claim without the amendments made by Schedule 14 to this Act.

If any claim is made by virtue of sub-paragraph (1) above in respect of the relievable amount for an accounting period beginning on or after 1st April 1996, then an amount equal to the amount to which the claim relates shall be deemed, for the purposes of the computation falling to be made for that accounting period under section 82 of this Act, to be brought into account for that period as a non-trading credit.

(3) The references in this paragraph and paragraph 24 below to provisions of the Finance Act 1993 shall have effect as including references to those sections as applied by the provisions of Chapter II of Part IV of the Finance Act 1994.

(4) Sub-paragraph (3) above is without prejudice to the generality of section 20(2) of the Interpretation Act 1978 (references to other enactments).

12.9.31.2.FA 1996 Sch.15 para.24

Exchange losses etc. carried forward from before 1st April 1996

Where there is any amount which apart from this Chapter would fall under section 131(12) of the Finance Act 1993 (carrying forward of exchange gains and losses) to be carried forward to an accounting period ending on or after 1st April 1996, that amount shall be treated in relation to that period as an amount carried forward to that period in pursuance of section 83(3) of this Act.

12.9.32.FA 1996 SCHEDULE 40

Gilt stripping: taxation provisions

12.9.32.1.FA 1996 Sch.40 para.7

In the Taxes Act 1988, the following section shall be inserted after section 730B-

"Exchanges of gilts: traders etc.

730C. - (1) This section has effect for the purposes of computing the profits and gains arising from any trade, profession or vocation carried on by any person in so far as the computation is such as to require amounts in respect of the acquisition or redemption of a gilt-edged security (including any strip) to be brought into account.

(2) Where a gilt-edged security is exchanged by any person for strips of that security-

(a) the security shall be deemed to have been redeemed at the time of the exchange by the payment to that person of its market value; and

(b) that person shall be deemed to have acquired each strip for the amount which bears the same proportion to that market value as is borne by the market value of the strip to the aggregate of the market values of all the strips received in exchange for the security.

(3) Where strips of a gilt-edged security are consolidated into a single security by being exchanged by any person for that security-

(a) each of the strips shall be deemed to have been redeemed at the time of the exchange by the payment to that person of the amount equal to its market value; and

(b) that person shall be deemed to have acquired the security for the amount equal to the aggregate of the market values of the strips given in exchange for the security.

(4) References in this section to the market value of a security given or received in exchange for another are references to its market value at the time of the exchange.

(5) Subsections (3) and (4) of section 473 shall not apply in the case of any exchange to which subsection (2) or (3) above applies.

(6) Without prejudice to the generality of any power conferred by section 202 of the Finance Act 1996, the Treasury may by regulations make provision for the purposes of this section as to the manner of determining the market value at any time of any gilt-edged security (including any strip).

(7) Regulations under subsection (6) above may-

(a) make different provision for different cases; and

(b) contain such incidental, supplemental, consequential and transitional provision as the Treasury may think fit.

(8) This section does not apply for the purposes of corporation tax.

(9) In this section-

"gilt-edged security" has the same meaning as in section 51A; and

"strip" means anything which, within the meaning of section 47 of the Finance Act 1942, is a strip of a gilt-edged security."

12.10. Finance Act 1997

12.10.1. FA 1997 S.76

Stock lending and manufactured payments.

Schedule 10 to this Act (which makes provision for the treatment for the purposes of income tax, corporation tax and capital gains tax of stock lending arrangements and manufactured payments) shall have effect.

12.10.2. FA 1997 S.77

Bond washing and repos.

(1) After subsection (2A) of section 731 of the Taxes Act 1988 (disapplication of bond washing rules where buyer has to make manufactured payment) there shall be inserted the following subsections-

"(2B) Subject to subsection (2E) below, where there is a repo agreement in relation to any securities-

(a) neither-

(i) the purchase of the securities by the interim holder from the original owner, nor

(ii) the repurchase of the securities by the original owner,

shall be a purchase of those securities for the purposes of subsection (2) above; and

(b) neither-

(i) the sale of the securities by the original owner to the interim holder, nor

(ii) the sale by the interim holder under which the securities are bought back by the original owner,

shall be taken for the purposes of subsection (2) above to be a subsequent sale of securities previously purchased by the seller.

(2C) Accordingly, where there is a repo agreement, the securities repurchased by the original owner shall be treated for the purposes of subsection (2) above (to the extent that that would not otherwise be the case) as if they were the same as, and were purchased by the original owner at the same time as, the securities sold by him to the interim holder.

(2D) For the purposes of subsections (2B) and (2C) above there is a repo agreement in relation to any securities if there is an agreement in pursuance of which a person ("the original owner") sells the securities to another ("the interim holder") and, in pursuance of that agreement or a related agreement, the original owner-

(a) is required to buy back the securities;

(b) will be required to buy them back on the exercise by the interim holder of an option conferred by the agreement or related agreement; or

(c) is entitled, in pursuance of any obligation arising on a person's becoming entitled to receive an amount in respect of the redemption of those securities, to receive from the interim holder an amount equal to the amount of the entitlement.

(2E) Subsections (2B) and (2C) above do not apply if-

(a) the agreement or agreements under which the arrangements are made for the sale and repurchase of the securities are not such as would be entered into by persons dealing with each other at arm's length; or

(b) any of the benefits or risks arising from fluctuations, before the securities are repurchased, in the market value of the securities in question accrues to or falls on the interim holder.

(2F) Section 730B applies for the purposes of subsections (2B) to (2E) above as it applies for the purposes of section 730A."

(2) This section applies in relation to cases in which the interest becomes payable on or after the day on which this Act is passed.

12.10.3. FA 1997 S.91

Disposals of loan relationships with or without interest.

(1) Section 807A of the Taxes Act 1988 (disposals and acquisitions of company loan relationships with or without interest) shall be amended as follows.

(2) At the beginning of subsection (2) there shall be inserted "Subject to subsection (2A) below,".

(3) After that subsection there shall be inserted the following subsection-

"(2A) Tax attributable to interest accruing to a company under a loan relationship does not fall within subsection (2) above if-

(a) at the time when the interest accrues, that company has ceased to be a party to that relationship by reason of having made the initial transfer under or in accordance with any repo or stock-lending arrangements relating to that relationship; and

(b) that time falls during the period for which those arrangements have effect."

(4) In subsection (3)(b), after "related transaction" there shall be inserted "other than the initial transfer under or in accordance with any repo or stock-lending arrangements relating to that relationship".(5) After subsection (6) there shall be inserted the following subsection-

"(6A) In this section "repo or stock-lending arrangements" has the same meaning as in paragraph 15 of Schedule 9 to the Finance Act 1996 (repo transactions and stock-lending); and, in relation to any such arrangements-

(a) a reference to the initial transfer is a reference to the transfer mentioned in sub-paragraph (3)(a) of that paragraph; and

(b) a reference to the period for which the arrangements have effect is a reference to the period from the making of the initial transfer until whichever is the earlier of the following-

(i) the discharge of the obligations arising by virtue of the entitlement or requirement mentioned in sub-paragraph (3)(b) of that paragraph; and

(ii) the time when it becomes apparent that the discharge mentioned in sub-paragraph (i) above will not take place."

(6) Subsections (2) and (3) above have effect in relation to interest accruing on or after 1st April 1996.

(7) Subsection (4) above has effect in relation to transactions made on or after 26th November 1996.

12.11. Finance (No 2) Act 1997

12.11.1. F(No. 2)A 1997 S.37

Gilt-edged securities Interest to be paid gross.

(1) The Taxes Act 1988 shall be amended as follows.

(2) In section 50 (Treasury direction for payment of public revenue dividends without deduction of tax), before subsection (1) there shall be inserted the following subsection-

"(A1) The interest on registered gilt-edged securities (whenever issued and whatever the terms on which they were issued) shall be paid without deduction of income tax."

(3) In that section-

(a) in subsection (1), after "following securities" there shall be inserted "in so far as they are not gilt-edged securities";

(b) in subsection (2), after "by virtue of" there shall be inserted "subsection (A1) above or of";

(c) in subsection (3), for "to which subsection (1) above applied" there shall be substituted "the interest on which is to be paid without deduction of income tax"; and

(d) in subsections (4) and (5), for the words "two months", in each place where they occur, there shall be substituted "one month".

(4) In subsection (7) of that section, after "requires" there shall be inserted the following definition-

"'gilt-edged securities' means any securities which-

(a) are gilt-edged securities for the purposes of the 1992 Act; or

(b) will be such securities on the making of any order under paragraph 1 of Schedule 9 to that Act the making of which is anticipated in the prospectus under which they were issued,".

(5) Section 51A (interest on gilt-edged securities held under authorised arrangements to be paid without deduction of tax) shall cease to have effect.

(6) In section 51B (periodic accounting for tax on interest on gilt-edged securities), for subsection (5) there shall be substituted the following subsections-

"(5) In this section "relevant gilt-edged securities" means securities of one of the following descriptions-

(a) gilt-edged securities issued before 6th April 1998 other than those in relation to which a direction under section 50(1) was given before that date;

(b) gilt-edged securities issued on or after that date in relation to which the Treasury have given a direction that they may be subjected to periodic accounting;

and in this subsection "gilt-edged securities" has the same meaning as in section 50.

(5A) Regulations under this section shall not apply to a payment of interest on any relevant gilt-edged securities if that payment is made at any time after the Treasury have given a direction that those securities are to be exempted from periodic accounting."

(7) In sections 722A(5) and 730C(9), and in paragraph 3A(2)(a) of Schedule 23A, (which all define "gilt-edged securities" by reference to section 51A of the Taxes Act 1988), for "51A" there shall be substituted, in each case, "50".

(8) Subject to subsections (9) to (13) below, this section has effect in relation to payments of interest falling due on or after 6th April 1998.

(9) Subsection (3)(d) above has effect in relation to applications made and notices given at any time on or after the day on which this Act is passed.

(10) Where-

(a) any person holds any gilt-edged securities in relation to which a direction was given under section 50(1) of the Taxes Act 1988 at any time before 6th April 1998, and

(b) that person at any time before that date made an application under section 50(2) of that Act with respect to those securities,

that application (unless withdrawn) shall have effect in relation to any interest on those securities to which section 50(A1) of that Act applies as it previously had effect in relation to any interest on those securities to which that direction applied.

(11) Sections 50, 51B and 118D(4) of the Taxes Act 1988 shall have effect in relation to any gilt-edged securities issued before 6th April 1998 which-

(a) are securities the interest on which, if paid immediately before that date, would have fallen to be paid after deduction of income tax, and

(b) are registered within the meaning of section 50 of that Act but are not securities in relation to which any direction under section 50 of that Act was given before that date,

as if the appropriate person had so made an application under section 50(2) of that Act as to enable that application to take effect in relation to payments of interest made on or after that date.

(12) In subsection (11) above "the appropriate person" means-

(a) in the case of securities transferred before 6th April 1998 but after the time when the balance was struck for a dividend on them falling due on or after that date, the person who held the securities at the time when the balance was so struck;

(b) in any other case, the person holding the securities in question immediately before 6th April 1998.

(13) Section 50(5) of the Taxes Act 1988 shall have effect in relation to an application treated as made by virtue of subsection (11) above as if a notice withdrawing that application was capable of being given at any time on or after the passing of this Act.

12.11.2. F(No. 2)A 1997 S.40

Carry-back of loan relationship deficits.

(1) Chapter II of Part IV of the Finance Act 1996 (loan relationships) shall be amended as follows.

(2) In paragraph 3(7) of Schedule 8 (permitted period of three years for carry-back of deficits), for "three years" and "three year" there shall be substituted, in each case, "twelve months".

(3) In sub-paragraph (3) of paragraph 4 of Schedule 11 (carry-back of deficit by insurance companies)-

(a) for paragraph (a) there shall be substituted the following paragraph-

"(a) carried back to accounting periods falling wholly or partly within the period of twelve months immediately preceding the deficit period; and"; and

(b) in paragraph (b), for "those periods" there shall be substituted "up to three such periods".

(4) In sub-paragraph (5) of that paragraph (mechanism for carry-back in the case of insurance companies), for "the three accounting periods preceding the deficit period" there shall be substituted "accounting periods falling wholly or partly within the period of twelve months mentioned in sub-paragraph (3)(a) above".

(5) In sub-paragraph (8) of that paragraph (which defines the set-off periods), in each of paragraphs (b) and (c), for "immediately preceding" there shall be substituted "(if any) which falls wholly or partly within the period of twelve months mentioned in sub-paragraph (3)(a) above and immediately precedes".

(6) In sub-paragraph (9) of that paragraph (adjusted amount of a company's eligible profit), after "is" there shall be inserted "(subject to sub-paragraph (9A) below)"; and after that sub-paragraph there shall be inserted the following sub-paragraph-

"(9A) Where a set-off period falls only partly within the period of twelve months mentioned in sub-paragraph (3)(a) above, the adjusted amount of a company's eligible profit for that period shall be taken to be confined to the part of the amount computed under sub-paragraph (9) above which is proportionate to the part of the set-off period that falls within that period of twelve months."

(7) Subject to subsection (8) below, this section has effect in relation to any deficit for a deficit period ending on or after 2nd July 1997.

(8) Paragraph 3 of Schedule 8 to the Finance Act 1996 shall have effect in relation to any deficit for a deficit period beginning before but ending on or after 2nd July 1997 as if the permitted period in relation to the pre-commencement part of the deficit were the period beginning with 1st April 1996 and ending immediately before the beginning of the deficit period.

(9) Where for the purposes of paragraph 23 of Schedule 15 to the Finance Act 1996 (transitional provision in connection with the carrying back of exchange losses) there is a relievable amount for an accounting period ending on or after 2nd July 1997, that paragraph shall have effect, except in relation to any pre-commencement part of that amount, as if, in section 131(10)(b) of the Finance Act 1993 (the permitted period) as applied by that paragraph, the words "twelve months" were substituted for the words "three years".

(10) In this section "pre-commencement part", in relation to the deficit for any deficit period or the relievable amount for any accounting period, means the part (if any) of that deficit or relievable amount which, on an apportionment in accordance with subsection (11) or, as the case may be, (12) below, is attributable to such part (if any) of that period as falls before 2nd July 1997.

(11) Except in a case where subsection (12) below applies, an apportionment for the purposes of subsection (10) above shall be made on a time basis according to the respective lengths of the part of the deficit period or, as the case may be, accounting period falling before 2nd July 1997 and the remainder of that period.

(12) Where the circumstances of a particular case are such that the making of an apportionment on the time basis mentioned in subsection (11) above would work in a manner that would be unjust or unreasonable in relation to any person, the apportionment shall be made instead (to the extent only that is necessary in order to avoid injustice and unreasonableness) in such other manner as may be just and reasonable.

12.12. Finance Act 1998

12.12.1. FA 1998 S.82

Carry forward of non-trading deficit on loan relationships.

(1) In section 83 of the Finance Act 1996 (non-trading deficit on loan relationships), for subsections (3) and (4) substitute-

"(3) So much of the deficit for the deficit period as is not the subject of a claim under subsection (2) above shall be carried forward and treated as a deficit for the next accounting period.

(4) An amount carried forward to an accounting period under subsection (3) above-

(a) may be the subject of a claim under paragraph (d) of subsection (2) above, but not under any other paragraph of that subsection, and

(b) shall be disregarded for the purposes of any claim under that subsection relating to a deficit arising in that period.".

(2) Section 797 (limits on credit: corporation tax) and section 797A (foreign tax on interest brought into account as a non-trading credit) of the Taxes Act 1988 are amended as follows-

(a) in section 797(3B)(b), omit "or in accordance with subsection (3) of that section";

(b) in section 797A(5), at the end of paragraph (a) insert the word "and" and omit paragraph (c) and the word "and" preceding it;

(c) at the end of section 797A(5), insert- "An amount carried forward to the applicable accounting period under section 83(3) of that Act shall not be treated as a non-trading deficit for that period for the purposes of paragraphs (a) and (b).";

(d) in section 797A(6), for "specified in subsection (5)(c) above" substitute "carried forward to the applicable accounting period in pursuance of a claim under section 83(2)(d) of that Act";

(e) at the end of section 797A(7) insert- "An amount carried forward to the applicable accounting period under section 83(3) of the Finance Act 1996 shall be disregarded for the purposes of paragraphs (a) and (b).".

(3) The following amendments of Schedule 28A to the Taxes Act 1988 (change in ownership of investment company: deductions) are consequential on the amendment in subsection (1) above-

(a) in paragraph 6(da), after "period" insert "(other than one within sub-paragraph (dc) below)";

(b) in paragraph 6(db), omit "(dc) or";

(c) in paragraph 6(dc), for "debit given for that accounting period by" substitute "deficit carried forward to that accounting period under";

(d) in paragraph 7(1)(b), for "debit" substitute "deficit";

(e) in paragraph 11(2), omit paragraph (a);

(f) in paragraph 13(1)(ea), after "period" insert "(other than one within paragraph (ec) below)";

(g) in paragraph 13(1)(eb), omit "(ec) or";

(h) in paragraph 13(1)(ec), for "debit given for that accounting period by" substitute "deficit carried forward to that accounting period under";

(i) in paragraph 16(1)(b), for "debit" substitute "deficit".

(4) The amendments made by this section shall be deemed always to have had effect.

12.12.2. FA 1998 S.103-107

These restrict double taxation relief on certain interest and dividends. As they have only limited implications for debt and interest, to save space they are not reproduced here.

12.13. Finance Act 1999

12.13.1. FA 1999 S.65

Securities and investments Relevant discounted securities.

(1) In paragraph 3 of Schedule 13 to the Finance Act 1996 (meaning of "relevant discounted security"), for sub-paragraph (1) there shall be substituted the following sub-paragraphs-

"(1) Subject to the following provisions of this paragraph and paragraph 14(1) below, in this Schedule "relevant discounted security" means any security which (whenever issued) is such that, taking the security as at the time of its issue, the amount payable on redemption-

(a) on maturity, or

(b) in the case of a security of which there may be a redemption before maturity, on at least one of the occasions on which it may be redeemed,

is or would be an amount involving a deep gain, or might be an amount which would involve a deep gain.

(1A) The occasions that are to be taken into account for the purpose of determining whether a security is a relevant discounted security by virtue of sub-paragraph (1)(b) above shall not include any of the following occasions on which it may be redeemed, that is to say-

(a) any occasion not falling within sub-paragraph (1C) below on which there may be a redemption otherwise than at the option of the person who holds the security;

(b) in a case where a redemption may occur as a result of the exercise of an option that is exercisable-

(i) only on the occurrence of an event adversely affecting the holder, or

(ii) only on the occurrence of a default by any person,

any occasion on which that option is unlikely (judged as at the time of the security's issue) to be exercisable;

but nothing in this sub-paragraph shall require an occasion on which a security may be redeemed to be disregarded by reason only that it is or may be an occasion that coincides with an occasion mentioned in this sub-paragraph.

(1B) In sub-paragraph (1A) above "event adversely affecting the holder", in relation to a security, means an event which (judged as at the time of the security's issue) is such that, if it occurred and there were no provision for redemption, the interests of the person holding the security at the time of the event would be likely to be adversely affected.

(1C) An occasion on which there may be a redemption of a security falls within this sub-paragraph if-

(a) the security is a security issued to a person connected with the issuer; or

(b) the obtaining of a tax advantage by any person is the main benefit, or one of the main benefits, that might have been expected to accrue from the provision in accordance with which it may be redeemed on that occasion.

(1D) In sub-paragraph (1C) above "tax advantage" has the meaning given by section 709(1) of the Taxes Act 1988.

(1E) Subject to sub-paragraph (1F) below, where a security which is not a relevant discounted security but which would have been such a security if it had been issued to a person connected with the issuer-

(a) is acquired by a person who is so connected, or

(b) is held by a person who becomes so connected,

this Schedule shall have effect, in relation to times falling at or after the time of the acquisition or, as the case may be, the time when that person became so connected, as if the security were a relevant discounted security.

(1F) Where a security which-

(a) is a relevant discounted security, but

(b) would not be such a security but for sub-paragraph (1C)(a) or (1E) above,

is acquired by a person who is not connected with the issuer, this Schedule shall have effect, in relation to that person, as if the security ceased to be a relevant discounted security at the time of the acquisition."

(2) After sub-paragraph (2) of that paragraph there shall be inserted the following sub-paragraphs-

"(2A) Nothing in sub-paragraph (2)(c) above shall prevent a security that would have been a relevant discounted security if it had been issued to a person connected with the issuer from being treated as a relevant discounted security by virtue of sub-paragraph (1E) above.

(2B) Nothing in sub-paragraph (2)(f) above shall prevent a security from being treated as a relevant discounted security by virtue of sub-paragraph (1C)(a) or (1E) above."

(3) Sub-paragraph (5) of that paragraph shall cease to have effect.(4) After sub-paragraph (6) of that paragraph there shall be inserted the following sub-paragraphs-

"(7) Section 839 of the Taxes Act 1988 (connected persons) applies for the purposes of this paragraph.

(8) In determining for the purposes of sub-paragraph (1C), (1E), (1F) or (2A) above whether a person is or becomes connected with the issuer, no account shall be taken of-

(a) the security mentioned in that sub-paragraph; or

(b) any security issued under the same prospectus as that security."

(5) In paragraph 10 of that Schedule (issue of securities in separate tranches), after sub-paragraph (3) there shall be inserted the following sub-paragraph-

"(4) For the purpose of determining whether a security held by a person who is not connected with the issuer is a relevant discounted security by virtue of this paragraph, a security which-

(a) is a relevant discounted security, but

(b) would not be such a security but for paragraph 3(1C)(a) or (1E) above,

shall be assumed not to be a security falling within sub-paragraph (1)(b) above."

(6) In paragraph 13 of that Schedule (excluded indexed securities), after sub-paragraph (8) there shall be inserted the following sub-paragraph-

"(9) In this paragraph references to redemption, in relation to a security, do not include references to redemption of the security on any such occasion as, by reason of sub-paragraph (1A) of paragraph 3 above, is not to be taken into account for the purpose of determining whether the security is a relevant discounted security by virtue of sub-paragraph (1)(b) of that paragraph."

(7) In section 92 of that Act, after subsection (6) there shall be inserted the following subsections-

"(7) Where an asset representing a creditor relationship of a company-

(a) ceases at any time to be an asset to which this section applies, but

(b) does not cease at that time to represent a creditor relationship of that company,

the company shall be deemed for the purposes of the Taxation of Chargeable Gains Act 1992 and this Chapter to have disposed of the asset immediately before that time for the relevant consideration, and to have re-acquired it immediately after that time for the relevant consideration.

(8) Any deemed disposal and re-acquisition under subsection (7) above shall be treated for the purposes of that Act of 1992 as a transaction in the case of which-

(a) sections 127 to 130 of that Act would apply, apart from the provisions of section 116 of that Act, by virtue of any provision of Chapter II of Part IV of that Act;

(b) the asset in question represents both the original shares and the new holding for the purposes of those sections;

(c) the market value of the asset at the time of the transaction is an amount equal to the relevant consideration.

(9) Subject to subsection (10) below, in subsections (7) and (8) above "the relevant consideration", in relation to an asset, means the amount that would have been taken, in accordance with the relevant accounting method, to be the value of the asset at the time of its deemed disposal if that method had been applied to the asset for tax purposes at all times until then.

(10) Subsection (5) above shall not apply in the case of a deemed disposal and re-acquisition under subsection (7) above; but the amount of the relevant consideration in such a case shall be treated for the purposes of the Taxation of Chargeable Gains Act 1992 as reduced by so much (if any) of the amount mentioned in subsection (9) above as is referable to interest which-

(a) is not paid or payable to the company before the time of the deemed disposal; but

(b) is interest falling to be brought into account under subsections (2) and (3) above as having accrued before that time.

(11) In subsection (9) above "the relevant accounting method", in relation to an asset representing a creditor relationship of a company, means the accounting method which, for the accounting period of that company in which the deemed re-acquisition takes place, is used as respects that asset and the part of that accounting period beginning with the deemed re-acquisition."

(8) Subject to subsections (9) to (12) below, subsections (1) to (7) above have effect in relation to-

(a) any transfer of a security on or after 15th February 1999; or

(b) any occasion on or after that date on which a person holding a security becomes entitled to any payment on its redemption.

(9) For the purposes of section 92 of that Act, subsections (1) to (7) above-

(a) have effect in relation to any accounting period of a company ending on or after 15th February 1999; but

(b) do not affect any amount falling to be brought into account in respect of any disposal (in whole or in part) of an asset representing a creditor relationship if the disposal was one completed before that day.

(10) For the purposes of paragraphs 17 and 18 of Schedule 9 to that Act, subsections (1) to (7) above-

(a) have effect in relation to any accounting period of a company ending on or after 15th February 1999; but

(b) do not affect any amount falling to be brought into account in respect of a security representing a debtor relationship of a company if, on that day, the company was no longer subject to any liability under the relationship.

(11) For the purposes of sections 117(2AA) and 251(8) of the Taxation of Chargeable Gains Act 1992, subsections (1) to (7) above have effect in relation to any disposal (in whole or in part) of an asset on or after 15th February 1999.

(12) For the purposes of subsection (1)(c) of section 254 of that Act (which, notwithstanding its repeal by the Finance Act 1998, continues to have effect in relation to loans made before 17th March 1998), subsections (1) to (7) above have effect in relation to any claim made on or after 15th February 1999.

13. Endnotes

[1] Adam Smith "The Wealth of Nations."
[2] "Strips and new instruments in the Gilt Edged Market" A consultative paper by the Bank of England May 1995
[3] "The Official Gilt Strips Facility: A paper by the Bank of England" October 1997
[4] Inland Revenue "Company Taxation Manual Volume V Loan Relationships" April 1999, abbreviated in the text to IRLRM
[5] The Chartered Institute of Taxation "Annotated Copy of the Finance Act 1996" published by Butterworths
[6] "Financial Instruments Tax & Accounting Review" Vol 2 No 1 page 9
[7] Accounting Standards Board Financial Reporting Standard 4 "Capital Instruments" issued December 1993
[8] "Tolley's Taxation of Corporate Debt and Financial Instruments" Second edition October 1998, by David Southern
[9] "Corporate & Government Debt – II" by John Lindsay in "Taxation" magazine 16 May 1996
[10] "Derivatives and Other Financial Instruments" Accounting Standards Board discussion paper July 1996