The Charity Law & Practice Review

THE CORPORATION TAX LOAN RELATIONSHIPS PROVISIONS

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1 Finance Act 1996 Changes

Sweeping changes have been made to the corporation tax treatment of profits and losses relating to loans and in particular to the payment and receipt of interest. There has been introduced a new and exclusive code, known as the Loan Relationships Provisions, contained in Finance Act 1996 Part IV Chapter II. The provisions potentially affect all corporate charities resident in the United Kingdom.

The broad effect of the provisions is to make sure that all profits of creditors, whether capital or income, are taxed as income, without any indexation relief, and that profits are taxed year by year as they accrue and not just on realisation. There are corresponding provisions to ensure that debtors can deduct not only interest paid but any other deficits, whether capital or income, on their borrowings, for example a premium payable on redemption of securities. The following is a very simplified account of some of the key provisions, with special emphasis on how they affect charities.

2 Loan Relationships

A company has a 'loan relationship' wherever the company stands in the position of a creditor or debtor as respects any money debt. Normally, the debt must be one arising from a transaction for the lending of money, unless an instrument has been issued for the purpose of representing security for the creditor.[2] All profits and gains arising from the loan relationships of a company (where it is the creditor) and any deficit on a company's loan relationships (where it is the debtor)

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2 In the case of a money debt which does not arise from a loan relationship, the provisions apply but only as respects *interest* payable to or by a company.

are to be computed for every accounting period in question. Normally, an accruals method can be used, although in some cases it is permissible to use a mark to market basis.

Trading-credits and debits in respect of individual transactions are then aggregated. The net figure is added to (or, in the case of a deficit, deducted from) trading profits.

Non-trading credits and debits are aggregated separately. If there is a balance of non-trading credits, this is taxable under Case III of Schedule D. Normally, if there is a deficit, e.g. because more interest is paid than received, the excess can be set off against various other profits of the company or other companies in the same group, as provided in section 83. Section 83(5) ominously provides, however, that 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.

4 Profits

Profits are taxable under Schedule D Case III. Since the amendment of Taxes Act 1988 section 505 by Finance Act 1996, all income under this Case qualifies for the charitable exemption.[3] It must, of course, be 'applied to charitable purposes only'.[4] Where the profits consist of cash income such as interest, the Loan Relationships Provisions do not give rise to any special difficulty. But what of the position where the profit which a charitable company is deemed to realise under the Provisions by the application of an accruals method of accounting is in fact an unrealised one? For example, a charity buys a zero coupon bond which in seven years will be redeemable at twice the issue price. Each year the charity is deemed to realise a part of the profit, yet in reality it realises nothing. How can it apply for charitable purposes a mere increase in value which it has not realised and therefore cannot spend?

5 Deficits

Section 83(5), discussed above, is prima facie alarming in that it appears to deny to charities a tax deduction allowed to any other taxpayer. Let us take as an example a corporate charity whose function is provide housing in the UK and

3 Section 505(1)(c)(ii).

4 And must not fall foul of the non-qualifying expenditure provisions.

which borrows to buy or improve properties and funds the interest out of the rents.

If it were not a corporate charity, it would be able to deduct the interest in computing its Schedule A liability. As a corporation, it cannot deduct interest otherwise than in accordance with the Loan Relationships Provisions: see Finance Act 1996 section 80(5) and see Taxes Act 1988 section 337A. And section 83(5) prevents it from obtaining any deduction under the Loan Relationships Provisions. It would thus appear that a corporate charity has an artificially high income as compared with a charitable trust or any other taxpayer, corporate or not!

In my view, there is no problem, so long as there is no breach of trust. The charitable company will prima facie be exempt from tax on its Schedule A income: Taxes Act 1988 section 505(1)(a). One of the conditions is that the income is 'applied for charitable purposes only'. Income will be so applied in so far as it is used in paying interest on a loan the proceeds of which were expended for its charitable purposes. Hence, the charity does in effect obtain a tax deduction in respect of the payment of the interest in that for every one pound of interest paid it will cease to be taxable on one pound of rent. The balance remaining after deducting the interest paid from the Schedule A income will qualify for the charitable exemption provided it is applied for charitable purposes only. That is quite fair and exactly the position that a charitable trust would find itself in in similar circumstances. Section 83(5) then makes sense as an attempt by the draftsman to ensure that a deduction is was not in effect obtained twice over.

6 Conclusion

The Loan Relationships Provisions were not drafted primarily with charities in mind. There are technical difficulties relating to obtaining the charitable exemption for profits on loan relationships which are in reality unrealised. A difficulty which apparently arises in respect of deductibility of interest turns out on closer inspection to pose no problem.