Company investment portfolios: the loan relationship trap

Large Corporate

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Company investment portfolios can trigger unexpected corporation tax liabilities where debt-based investments fall within the loan relationship.

Key Points

What is the issue?
Investment reports are often designed for individuals, but companies may be subject to different rules. Debt-based investments, including bonds and certain funds, can fall within the loan relationship regime rather than the chargeable gains regime.

What does it mean to me?
Companies need to identify which investments are loan relationships and analyse their fair value movements correctly. Unrealised gains may create taxable non-

trading credits even though the company has not disposed of the investment or realised any cash.

What can I take away?
Do not rely solely on an investment manager's tax report. Obtain a complete asset listing, classify each investment correctly, analyse fair value movements and exclude investments subject to the loan relationship rules from the company's chargeable gains computation.

Working in practice, it is a familiar occurrence that as a successful trading company reaches maturity, substantial wealth is generated. Many owner-managed businesses eventually accumulate surplus cash. Following a business sale, or simply through sustained profitability, those funds are often invested through a managed portfolio.

As tax advisers, we can feel reassured when handling the tax matters of such investments, as the reports which are produced by investment advisers often appear clear and comprehensive. They may include a consolidated tax certificate bringing together interest and dividend details, capital gains summaries and year-end valuations. So far so good. The tax position may be rather less straightforward, however.

These reports are typically designed with *individual* investors in mind. When applied to companies, things can go awry as not all investments are equal, at least not in tax terms. Advisers may instinctively treat investments as falling within the chargeable gains regime. The term 'investment' can too readily suggest that capital treatment is the right answer, leading us to apply the relevant tax adjustments almost as second nature.That assumption is generally correct for equities.

However, many debt-based investments instead fall within the loan relationships rules contained in the Corporation Tax Act (CTA) 2009 Part 5, rather than the chargeable gains code.

What is a loan relationship?

The statutory definition is found at CTA 2009 s 302:

'For the purposes of the Corporation Tax Acts a company has a loan relationship if:

a) the company stands in the position of a creditor or debtor as respects any money debt (whether by reference to a security or otherwise); and

b) the debt arises from a transaction for the lending of money.’

To apply this definition in an investment portfolio context, let’s take an investment in a bond or a gilt (UK government loan stock) as an example.

These types of investment are fundamentally loans. A monetary sum is invested (or, in the legislative terminology, is an instance of ‘the lending of money’), and the company stands in the position of creditor to the entity issuing the bond or gilt. There will be an interest return on the sum invested and may also be a set date for the repayment of the initial capital.

This means that for corporation tax purposes, the taxation of this investment is dealt with under the non-trading loan relationship (NTLR) rules and, importantly, not under the chargeable gains regime. The key point is that gains or losses arising from investments that fall within the loan relationship rules are treated as ‘non-trading credits’ or ‘non-trading deficits’.

The taxation of loan relationship credits and deficits generally follows the amounts recognised in the accounts, subject to the specific computational rules and any required tax adjustments.

Fair value movements and corporation tax

All being well, the accounts will detail the interest and dividend income arising from the investment portfolio. The management fees incurred in handling the portfolio would sit as an expense in the profit and loss account. There would also likely be recognition of a profit or loss on disposal of assets and, lastly, some form of ‘fair value adjustment’ to reflect how the value of the investments has increased or decreased since the last reporting period. This is because, under FRS 102 (the main accounting standard applicable in the UK and Republic of Ireland), investments such as those under discussion would usually be accounted for at fair value.

Insofar as investments within the portfolio are treated as loan relationships, this means that the fair value movement recognised through the profit and loss account may contain elements that are taxable or relievable. If an affected investment has increased in value during the accounting period, the gain (or ‘non-trading credit’) would be taxable, despite no actual disposal having occurred. If an affected investment has decreased in value, the fair value loss (or ‘non-trading deficit’) may provide some immediate tax relief. The former is certainly more problematic, as it means that a tax liability may arise without any cash having been realised.

Example: Unrealised gains

A company holds a mixed investment portfolio. The annual report from the independent financial adviser (IFA) indicates total unrealised gains for the period of £30,000. Of this, £18,000 relates to equities and £12,000 relates to a strategic bond fund within the deemed loan relationship rules.

The £12,000 cannot simply be ignored because no disposal has occurred, nor should any disposals of that particular investment be included in a chargeable gains computation. It needs to be considered under the loan relationship rules, with the £12,000 unrealised gain being taxed as an NTLR credit.

Identifying loan relationships in practice

Investment portfolios commonly contain a mix of different types of investment to help diversify risk. The difficulty lies in determining accurately from the accounts which elements of the overall fair value movement during the accounting period are relevant to the loan relationship rules, so that the correct tax treatment can be applied.

Many investment portfolio reports make this very challenging. Reports may aggregate gains or valuation movements into a single figure. Given how the loan relationship regime can apply, the fact that a tax certificate reports a gain within a ‘capital gains summary’ should not be taken as evidence that the same amount belongs in a company’s chargeable gains computation.

Even if we assume that we have all the detail we could possibly want from the IFA, it may still prove troublesome to identify which assets fall within the NTLR regime and which do not.

Terminology is also an issue. Reports may use terms such as ‘strategic bond fund’, ‘enhanced cash fund’, ‘liquidity fund’, ‘money market fund’ or ‘fixed income portfolio', to give some real-world examples. But is it clear from the terminology alone whether the NTLR regime applies?

As a rule of thumb, an investment return in the form of interest is a good indicator that a loan relationship exists. A bond, for example, is essentially a loan and will typically stipulate a set repayment date. This would therefore bring it within the definition of a loan relationship in CTA 2009 s 302.

The position is more nuanced with funds such as open-ended investment companies and unit trusts. While the investment in the fund or unit trust is not itself strictly a 'lending of money', CTA 2009 contains deemed loan relationship rules for corporate holdings in certain investment funds.

Where the relevant conditions are met, including where the fund fails the qualifying investments test because more than 60% of its investments are qualifying investments, the company's holding is treated as a creditor relationship. Broadly, the legislation seeks to ensure that holdings in funds predominantly invested in debt-based investments cannot avoid loan relationship treatment simply because those investments are held through a collective vehicle.

As a result, advisers frequently need bespoke reconciliations from investment managers or must perform their own detailed analysis.

The relevant elements will need stripping out from the reports provided. Any disposals of affected investments listed in the chargeable gains section of the relevant tax report should also be excluded from the company's chargeable gains computation.

Gilts and corporate investors

The exemption for gains on gilts is well established for individual investors. For companies, however, another part of the legislation is relevant. CTA 2009 s 464 provides that the loan relationship rules take precedence over other tax treatments.

The point is not that the gilt exemption under the chargeable gains rules disappears. Rather, for a company, the more fundamental question is whether the return is brought into account under the loan relationship rules. Where CTA 2009 Part 5 applies, s 464 gives that regime priority for corporation tax purposes, so the analysis cannot stop at the capital gains tax treatment that would apply to an individual investor.

This can present a challenge, as IFAs may promote the tax-free benefits of gilts to clients, only for the tax adviser to have to explain the different tax treatment when preparing the company's corporation tax computation.

Managing the expectation gap

This is perhaps the most challenging aspect of all, as the tax treatment may not be obvious to the typical client. The additional work required on the corporation tax aspects is also likely to affect the fees charged, which will need to be communicated clearly. There may also be a difference between the tax treatment advised by the IFA and the conclusions reached by the tax adviser. Managing the client's expectations, and the relationships between the parties, sensitively will therefore be important.

Practical steps for tax advisers

Obtain a complete asset listing from the IFA so that the movements during the period for each investment can be determined. This may present systemic challenges for the IFA in obtaining the relevant information automatically and will often require manual analysis by the accountant or tax adviser.

Accurately classify the assets between those to be treated under the chargeable gains regime and those to be treated as loan relationships. Particular care is needed where the appropriate classification may not be obvious from the terminology given to the investment.

Analyse the fair value movement through the profit and loss account to distinguish between unrealised gains and losses arising from loan relationships and those relating to chargeable gains. This is key to identifying which figures should be included in the corporation tax computation as NTLR credits or deficits.

Review the report listing disposals of assets during the period to determine which are subject to the loan relationship rules. Any such disposals should be excluded from the chargeable gains reported in the corporation tax computation.

A final thought: micro-entity accounts

For some companies, adopting FRS 105 (the main accounting standard applicable to micro-entities) may alter the accounting presentation because micro-entity accounts do not recognise fair value adjustments in the same way. This may reduce some of the practical volatility, but it is not a universal answer. Eligibility to apply the standard, the wider accounting presentation and the corporation tax consequences would all need to be considered before treating this as a solution.