HMRC - CTM15502 - Interest Or Other Value In Respect Of Securities - Reasonable Commercial Return

CTA10/S1000 (1) E, CTA10/S1005, CTA10/S1006, CTA10/S1007, CTA10/S1008

CTA10/S1005 imposes a once and for all test at the time of the issue of the security to determine whether the return to the lender represents a reasonable commercial return.

The test:

Looks at the facts at the time of the issue of the security. There is no scope for considering later unforeseen events. If market interest rates at the time of issue were high and the security was issued at rates which were commercially reasonable at that time, it is not appropriate to reconsider the application of CTA10/S1005 simply because market rates subsequently became lower.

Looks solely at the position from the point of view of the lender and will include the element of risk present in making the investment in the security.

Is whether or not the return is commercially reasonable for the use of the principal secured. The test is the rate for the use of the money not the rate which is commercially justified for the overall transaction. The overall transaction might include consideration for other aspects, but the additional consideration is not a factor in considering the reasonableness of the return.

Risk

Risk is an essential element in considering whether or not the rate of return is commercially reasonable. It is inappropriate to consider that a certain interest rate represents a reasonable return at that time in all cases, because the amount of risk will vary according to the terms of each security.

A major factor to be considered is the risk the lender will not receive back some or all of the money invested. A security with low risk factor, such as government bonds, will pay a low rate of interest. In contrast, a security where there is a high risk of the investment not been repaid will need to pay a high rate of interest in order to attract investors.

The degree of risk associated with a security is a question of fact but it can be a complex area. In cases of difficulty, a Revenue Accountant can advise on whether the rate of return is commercially reasonable.

Replacement securities

If, at a time when market rates had decreased, a borrower issues new securities on the same terms as securities issued earlier, CTA10/S1000 (1) E might apply. CTA10/S1000 (1) E would apply to the amount of interest paid above that which would be commercially reasonable for a similar security issued at the time of the new security.

Reasonable commercial return: premium on early redemption

A company may borrow on a commercial basis such that, if the loan had run its full term, no distribution would arise. Because of movements in interest rates, the borrower may want to repay the loan early. If in such a case the borrowing company pays a premium on early repayment calculated on a commercial basis and both the lender and the borrower do not take distribution treatment, the Revenue will not seek a distribution.

You should take a broad view of what is a reasonable commercial return once the principal secured has been established if CTA10/S1000 (1) F does not apply, and

the consideration for the use of the principal is mainly interest, and

the interest is paid regularly, and

the company pays the interest to a company or companies which are within the charge to CT and which treats the interest as income chargeable to CT.

Issue of securities by intermediaries

Some issues are made by borrowers through merchant banks or other institutions (sometimes described as managers), who pay a premium on issue to the borrower but then reissue the security on to the market, usually at a discount to the nominal amount.

Although it seems that the managers are paying more than they will receive, the issue premium in these cases can reflect the way in which the managers are rewarded for arranging and underwriting the issue. A pointer to this arrangement will usually be the existence of a single manager with arrangements for reissue to a number of third parties, who are the ultimate lenders providing funds to the borrower.

In such cases, interest or other distributions may be no more than a reasonable commercial return for the use of the principal secured and, if that is so, CTA10/S1000 (1) E will not be in point.

Reasonable commercial return: security issued at a premium

CTA10/S1007 provides that for CTA10/S1000 (1) E purposes, the reasonable commercial return for the principal secured by a security is treated as the sum of:

a reasonable commercial return for the use of the principal, and

a reasonable commercial return for the use of the premium.

The premium is taken into account in determining a reasonable commercial return. This is because the premium is treated as income from the borrowing company’s loan relationship and consistency of treatment demands that the interest should be a deduction.

In some circumstances where the new consideration exceeds the principal secured, that new consideration is treated as the principal secured under CTA10/S1008 and CTA10/S1007 has no effect.

In most cases where CTA10/S1008 operates, the result will be the same as if CTA10/S1007 applied. However, CTA10/S1008 does not require the test of a reasonable commercial return to be applied separately to the principal secured and to the premium.

Reasonable commercial return: distributions where the principal secured is less than the amount invested

When the predecessor legislation to CTA10/S1000 (1) E (ICTA88/S209 (2)(d)) came into force, it did not cater for cases where the amount loaned exceeded the amount of capital repaid on redemption. With the exception of securities issued at a premium, such securities were rare. Financial institutions then developed new types of securities where there was no premium but where the amount guaranteed to be repaid on redemption could be much smaller. Such securities often reflect the value of assets or an asset index.

An example would be securities issued as ‘tracker funds’ designed to mimic the performance of the Stock Exchange. The securities may be sold to investors wishing an investment with the returns of the FTSE100. The investor hopes the FTSE100 index will rise in value, but the value of shares can fall. In such circumstances, the principal secured could fall to below the amount invested and might even become negligible.

Consider the case of £100 invested in a normal FTSE100 ‘tracker fund’. The return will be an amount commercially reasonable for that investment of £100. This is because the constituent shares are freely traded on the open market and the returns reflect the risk of holding such shares plus the dividends received on them. But CTA10/S1005 requires the test of commercial reasonableness to be measured against the principal secured, not the amount invested. The principal secured will be negligible because, in theory, the shares might lose almost all their value; any return on such a negligible principal would inevitably constitute more than a commercially reasonable return.

CTA10/S1008 applies for returns on investments on or after 17 April 2002 in certain circumstances where the principal secured is less than the amount of the new consideration. It operates by treating the amount of principal secured for the purposes of CTA10/S1000 (1) E as increased so that it equals the amount of new consideration. The effect is that for this kind of security, the test of commercially excessive interest applies by reference to the amount invested. It makes it less likely that interest will be re-characterised as a distribution.

The provision can apply to securities issued by any kind of company but, in practice, it will usually be relevant only to financial institutions such as banks and securities houses because other companies are likely to fall outside the conditions of CTA10/S1009 and CTA10/S1012 - see CTM15503.

Previous page

Next page