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Section 38: corporate interest restriction: minor amendments

The corporate interest restriction was enacted in Finance (No.2) Act 2017.¹ The legislation is complex, and experience of the rules in practice has meant that nearly every subsequent Finance Act has included technical amendments to the provisions.²

Finance Act 2021 (FA 2021) is no exception, containing two further amendments “to ensure the Corporate Interest Restriction operates as intended”.³ Of the two changes, the most significant in practice relates to the obligation for groups impacted by the restriction to file a corporate interest restriction return. The other amendment concerns how the corporate interest restriction applies to real estate investment trusts (REITs) and so should only affect a limited category of corporation taxpayers.

Compliance: the corporate interest return and “reasonable excuse”

The corporate interest restriction rules include a stand-alone compliance regime in Schedule 7A to the Taxation (International and Other Provisions) Act 2010 (TIOPA). Groups impacted by the corporate interest restriction can appoint a reporting company to take responsibility for the various compliance-related obligations set out in this Schedule.⁴ Generally mirroring the main corporation tax compliance rules,⁵ these obligations include the filing of a corporate interest restriction return for each period of account of the group no later than 12 months after the end of the period of account⁶ with late filing giving rise to a fixed penalty of up to £1,000.⁷ However, due to what HMRC describe as an “unintended omission”,⁸ the provisions did not provide for a

¹ Richard Collier, “Finance (No.2) Act 2017 Notes: Section 20 and Schedule 5: carried-forward losses; corporate interest restriction” [2017] B.T.R. 555.

² Finance Act 2018 s.24 and Sch. 8; Finance Act 2019 (FA 2019) s.28 and Sch.11 and see also Benjamin Crompton, “Finance Act 2018 Notes: Section 24 and Schedule 8: carried-forward losses; corporate interest restriction” [2018] B.T.R. 287.

³ HMRC, Policy Paper, *Technical amendments to the Corporate Interest Restriction for Corporation Tax* (21 July 2020), <https://www.gov.uk/government/publications/technical-amendments-to-the-corporate-interest-restriction-for-corporation-tax> [Accessed 16 August 2021].

⁴ Taxation (International and Other Provisions) Act 2010 (TIOPA) Sch.7A para.1.

⁵ Finance Act 1998 Sch.18.

⁶ TIOPA Sch.7A para.7.

⁷ TIOPA Sch.7A para.29.

⁸ *Finance Bill: Explanatory Notes* (2021), explanatory notes to Clause 38: Corporate interest restriction: minor amendments, <https://bills.parliament.uk/publications/41460/documents/201> [Accessed 16 August 2021], p.110, para.11.

“reasonable excuse” defence where a penalty is imposed for late-filing of a return.⁹ Hence, section 38(4) FA 2021.

Section 38(4) FA 2021 inserts a new paragraph 29A into Schedule 7A TIOPA. This provides that where the reporting company has a reasonable excuse for not submitting the return by the required filing date, no penalty will arise. The normal rules for determining what is (and what is not) a reasonable excuse apply.

Further, when that reasonable excuse then ceases to be available, the new paragraph 29A means that a reporting company should still be able to escape a penalty provided it files its (late) corporate interest restriction return without “unreasonable delay” once the excuse has ceased.

The new paragraph 29A is to be treated as having always had effect (i.e. since 1 April 2017).¹⁰ There may therefore be some groups that are eligible to claim back late-filing penalties that (because of the new paragraph 29A) were not actually due.

REITs and the corporate interest restriction

The corporate interest restriction applies to limit interest expense of REITs as it does to any other UK group, even though a REIT is exempt from corporation tax on profits and gains of its UK property rental business.

An interest disallowance in a REIT’s exempt business results in increased (exempt) property rental business profits. The REIT itself is not taxable on those profits. Instead, those profits are taken into account for the purposes of the property income dividend condition.¹¹

A disallowance of interest expense in a REIT’s exempt property rental business means an increased property income dividend requirement (and so potentially additional tax payable by shareholders). Further, in some cases this could lead to a REIT being required to pay a property income distribution of an amount in excess of the REIT’s distributable reserves (which cannot legally be paid).

Part 10 TIOPA therefore included special provision for REITs. Section 452 TIOPA allows (and in some cases effectively requires¹²) a REIT to allocate interest disallowance from its exempt property rental business to its residual (taxable) business. This is achieved by treating each type of business as carried on by a different company,¹³ which means the general rules for allocating interest disallowance between members of a worldwide group apply. Where a REIT allocates (some or all of) its exempt business interest disallowance to its residual (taxable) business, there is an increase in (taxable) profits arising in its residual business (on which the REIT is liable to corporation tax) but the corollary is that (some or all) interest expense can be deducted in working out its property income dividend requirement.¹⁴

⁹ The corporate interest restriction return is not a return listed in the table set out in Finance Act 2005 Sch.55 para.1.

¹⁰ Finance Act 2021 s.38(5).

¹¹ The property income distribution condition requires a REIT to distribute at least 90% of its (exempt) property rental business (income) profits each year: see Corporation Tax Act 2010 s.530.

¹² TIOPA s.452(5).

¹³ TIOPA s.452(3).

¹⁴ For an example of how this should work in practice, see HMRC, Internal Manual, *Corporate Finance Manual* (published 16 April 2016; updated 24 March 2021), <https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm97700> [Accessed 16 August 2021], CFM97710–CFM97746.

When section 452 TIOPA was enacted, only UK resident REIT members were within the scope of the corporate interest restriction. That changed on 6 April 2020 when non-resident company landlords were brought into charge to corporation tax on UK property business profits.¹⁵ Section 38(2) FA 2021 amends section 452 TIOPA by inserting a new section 452(2A) TIOPA—with the explanatory note saying that this follows on from extension of corporation tax to non-resident company landlords.

The reason for the change links to the territorial limits of corporation tax. A non-resident company landlord may not have any activities (other than its UK property rental business) within the scope of corporation tax. The new section 452(2A) TIOPA deems a REIT member to be carrying on a residual (taxable) business for the purposes of section 452 (regardless of whether any such business is carried on) and so appears intended to put beyond doubt how a non-resident REIT member benefits from section 452 TIOPA. However, the explanatory notes highlight that what HMRC are really wanting to put beyond doubt is

“that a non-resident company within a UK REIT group would face a UK corporation tax charge where a CIR disallowance is allocated to the residual business company”.¹⁶

Hence, the second limb of the new section 452(2A): the statement that, as a consequence of this deeming, amounts allocated to the deemed residual business are “accordingly” within the charge to corporation tax.

The new (and, according to HMRC, clarificatory) section 452(2A) TIOPA takes effect from 21 July 2020 (when a draft of section 38 was first published).¹⁷

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¹⁵ FA 2019 s.17 and Sch.5.

¹⁶ *Finance Bill: Explanatory Notes* (2021), explanatory notes to Clause 38: Corporate interest restriction: minor amendments, p.110, para.10; HMRC, Internal Manual, *Corporate Finance Manual* (published 16 April 2016; updated 24 March 2021), <https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm97700> [Accessed 16 August 2021] evidences that HMRC considered the provisions worked as intended in any event: see CFM97760, “Interest restriction: property and REITs: corporate non-resident landlords”.

¹⁷ HMRC, Policy Paper, *Technical amendments to the Corporate Interest Restriction for Corporation Tax* (21 July 2020).

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