These notes refer to the Finance Act 2009 (c.10) which received Royal Assent on 21 July 2009

FINANCE ACT 2009

EXPLANATORY NOTES

INTRODUCTION

Section 49 and Schedule 25: Transfer of Income Streams

Summary

1. Section 49 and Schedule 25 treat sales and other disposals of rights to receive future income streams as giving rise to income for corporation tax and income tax purposes, unless already provided by tax law. This treatment is subject to a number of express exceptions.

2. The purpose of the section and Schedule is to secure that (unless taxable as income) receipts derived from a right to receive income (and which are an economic substitute for income) are treated as income for the purposes of corporation tax and income tax.

Details of the Schedule

3. Part 1 contains rules for taxation of transfers of income streams made by corporate transferors.

4. Paragraph 1(1) sets out that the Part applies where a company makes a transfer to a person of a right to relevant receipts and the transfer of the right is not the consequences of the transfer to that person of the asset from which the receipts arise.

5. The transfer must be the consequence of the transfer of a right, and not simply an application of the transferor's income. Thus, the legislation cannot apply for instance where the trustees of a trust distribute trust income or apply trust income for the benefit of a beneficiary.

6. The requirement that the transfer is not the consequence of the transfer of the underlying asset is intended to make clear that the legislation will not apply in any case where there is an outright sale of the income-producing asset. In other words the legislation deals with the sale of income streams where the seller retains the underlying asset from which the income arises or where the seller transfers the stripped asset to another person, or where there is no underlying asset.

7. Sub–paragraph (1)(b) highlights the exception to the rule that the underlying asset must be transferred in sub–paragraph (3) for transfers of rights to annual payments.

8. Paragraph 1(2) defines relevant receipts as any income which but for the transfer would be charged to corporation tax as income of the transferor or brought into account in calculating profits of the transferor for the purposes of corporation tax. The reason for referring to income that is brought into account in calculating profits is to ensure that the sale of a right to income which would be a component in the calculation of profits from a trade or other business is included as well as sale of pure income. The words "but for the transfer" indicate that the legislation cannot apply where the transferor remains taxable on the income.

9. The requirement that relevant receipts are those which would be receipts of the transferor but for the transfer is included to emphasise that the legislation is not concerned with the *creation* of income receipts for example by the entering into of the contract giving rise to the receipts. A useful distinction has been drawn by, in particular, courts in the United States of America, between a "right to earn income" and a "right to earned income". See in this regard the discussion in *Lattera & Lattera v Commissioner* [437 F.3d 399 - 3rd Circuit Court of Appeals 2006 http://www.ca3.uscourts.gov/opinarch/044721p.pdf]. This legislation, like many of the provisions it replaces such as section 730 of the Income and Corporation Taxes Act 1988 (ICTA), deals with transferable income which the payer would have paid regardless of the transfer with the transfer simply meaning that it is now received by another person.

10. Paragraph 1(3) contains the exception to the requirement that the underlying asset is not transferred and applies where that asset is all rights under an agreement for annual payments. This exception reflects the fact that such an agreement is indistinguishable from a right to relevant receipts so that it is appropriate to treat the outright transfer of the agreement in the same way as a transfer of the right to relevant receipts. The transfer of all rights under an agreement for annual payments is currently taxed as income under section 775A of ICTA. This rule applies only where what the income that is transferred what constitute annual payments in the hands of the transferor. Where the transferor carries on a trade such that the income stream would not have been pure income profit in its hands, then paragraph 1(3) can have no application.

11. Paragraph 1(3) also ensures that where a transfer of an asset is made under an agreement that provides for its repurchase then for the purposes of paragraph 1(1) the asset is to be treated as not having been transferred.

12. Paragraph 1(4) explains that paragraph 2 sets out what happens where this Part applies.

13. Paragraph 1(5) signposts the exclusions from the charge under the legislation set out in paragraphs 3 and 4.

14. Paragraph 1(6) signposts that paragraph 5 makes specific provision for transfers of partnership shares.

15. Paragraph 1(7) indicates that paragraph 6 contains supplementary provision

16. Paragraph 2(1) provides that the "relevant amount" is to be treated as income of the transferor chargeable to corporation tax in the same way and to the same extent as the relevant receipts would have been. By use of the words "to the same extent", the legislation limits the charge to corporation tax on the transfer of relevant receipts in a case where the receipts (although wholly of an income nature) would have not have been wholly taxed as income.

17. For instance, lease rentals payable to a company under a long funding lease within the meaning of Chapter 6A of Part 2 of the Capital Allowances Act 2001 (CAA), although income, are not wholly taxed as income but are taken into account as elements in determining the taxable finance return. The reference to "the same extent" in paragraph 2(1) ensures that if the right to such a rental payment were sold only the part of the consideration that represents the amount that would have been taxed as income is to be charged. So a sale of the right to the finance margin would be taxable, but a sale of the "principal" would not be. Similarly, if the relevant receipts arise from anything which would produce credits or debits in relation to the company under Part 5 (loan relationships), Part 7 (derivative contracts) or Part 8 (intangible fixed assets) but those debits or credits would have been disregarded under those Parts then a transfer of the right to those amounts will be disregarded to the same extent that the receipts themselves would have been.

18. This sub-paragraph, which is the operative provision for the Schedule, brings the relevant amount into account in the same way as that in which the income or other receipts would have been chargeable had there been no transfer of the rights to them.

19. Paragraph 2(2) defines “the relevant amount”. Normally it is the amount of the consideration for the transfer of the right to the relevant receipts. But where the amount of the consideration is substantially less than the market value of the right to the relevant receipts (or where there is no consideration) then the excess is additionally to be treated as income of the transferor. The market value rule is intended to apply only exceptionally where it is clear that the transaction is either not at arm’s length or where the transaction has been structured to make it appear that there is less “consideration” than the value actually given for the right to relevant receipts. This reflects the concerns that led to the amendment to section 785A of ICTA made by paragraph 1 of Schedule 22 to the Finance Act (FA) 2008, which was designed to block schemes purporting to side-step section 785A by transferring rights to lease rentals in exchange for value which, it was argued, was not “consideration” under English law.

20. Paragraph 2(3) contains the timing rule for the purposes of the charge to tax in relation to the taxable sum identified under paragraph 2(1). In cases where consideration is the measure of the income, it is to be treated as arising when it is, in accordance with generally accepted accounting practice (GAAP), recognised in the transferor’s profit and loss account or income statement. Where market value is used, then the excess over the consideration is to be treated as arising at the same time that it would have been recognised if consideration equal to full market value had been received.

21. Paragraph 2(4) gives the timing rule where the rule in sub–paragraph (3) would not involve full recognition of the income. In such a case, the amount that would not be recognised is to be treated as arising at the time that it becomes reasonable to assume that not all the income would, by virtue of sub-paragraph (3), be recognised in an accounting period of the company. Thus the taxable amount identified under paragraph 2(1) (which may be less than the relevant amount) will always be taxed in full, with the timing governed either by sub–paragraph (3) or (4).

22. Paragraph 3 sets out an exception. Paragraph 3 replaces clause 1(6) in the consultation document published containing a draft of this Schedule. The exception applies where and to the extent that the income under paragraph 1(1) is:

- already charged to tax as income;
- brought into account in calculating any income; or
- brought into account for the purposes of CAA.

23. Paragraph 4 recognises that some transfers of the right to relevant receipts are in substance a transfer by way of security only. So the section does not apply if the transferor transfers the rights to the income streams as part of a structured finance arrangement and the consideration is an “advance” to the transferor or a partnership of which the transferor is a member for the purposes of the legislation in sections 774A to 774G of ICTA. This deals with comments made on the consultation document on this point.

24. Paragraph 5 prevents the Part from applying to virtually all transfers of the right to relevant receipts that result from a reduction in a company’s share in profits of a partnership of which it is a member. Specifically, it treats the transfer of such a right as the consequence of the transfer of the asset from which those receipts arise if either Condition A or B is met (such that paragraph 1(1)(b) does not then apply, so the Part cannot apply).

25. Condition A is contained in paragraph 5(2) and is that there is a reduction in the transferor’s share in the overall partnership property and the reduction in the transferor’s entitlement to relevant receipts is in the same proportion. This means that a simple reduction in a partner’s interest in a partnership cannot trigger the application of the legislation.

26. Condition B is contained in paragraph 5(3) and is that it is not the main purpose or one of the main purposes of the transfer to secure that the relevant receipts are not charged to corporation tax or income tax on any partner. Thus the legislation can apply only where the main or one of the main purposes is to secure that no partner is charged to such tax on the relevant receipts (and only then if Condition A is not met). It follows that this rule cannot apply so long as the relevant receipts do not cease to be within the charge to tax (and even if they do cease to be within the charge it was a main purpose to secure that result).

27. Paragraph 6(1) provides that certain transactions that may transfer income but arguably do not involve a transfer of the asset from which the income arises are to be treated as transfers of assets. This ensures that the Part will not apply to such income transfers. The transactions in question are the grant or surrender of a lease in land, the disposal of an interest in an oil licence, and the grant or disposal of any interest in intellectual property which constitutes a pre-2002 asset within the meaning of section 881 of the Corporation Tax Act 2009 (CTA).

28. Paragraph 6(2) allows HM Treasury a power by way of order to secure that other transactions shall be treated as the transfer of assets.

29. Paragraph 6(3) further explains the use of the word “transfer” as per paragraphs 1 to 4. It follows the original Clause 1(8) in respect of which the December 2007 consultation document said “Transfer is defined very widely in subsection (8) to include specific realisation events such as sale, exchange, gift or assignment and also any arrangements that equate in substance to a transfer. This might include transactions involving options, total return swaps, etc. It would not, however, cover transactions which amount, in form to a transfer, but, in substance to, say, the giving of security such as in a repo.” The paragraph also further explains the use of the phrase “a transfer taking place” in the case of wider non-sale etc arrangements so that it also includes the making of that arrangement.

30. Paragraph 6(4) makes clear that a transfer by a partnership of which a company is a member is to be treated as a transfer to which the Part applies. Similarly a transfer by a company to a partnership of which the company is a member or to the trustees of any trust of which the transferor is a beneficiary counts as a transfer.

31. This ensures that where a partnership enters into a transaction to which the Part applies, each the member of the partnership is charged as if it had disposed of its share of relevant receipts for its share of the consideration received by the partnership. Similarly, if a partner transfers relevant receipts to a partnership then it may be charged but only in relation to those relevant receipts on which it is no longer taxable as part of its share of profits.

32. Paragraph 7 makes similar provision to paragraphs 1 to 6 for income tax. It does so by inserting a new Chapter 5A into Part 13 of the Income Tax Act 2007 (ITA) consisting of new sections 809AZA to 809AZF.

33. These provisions match those in paragraphs 1 to 6 and differ only to the extent necessary to cater for the different structure of income tax. The notes below refer only to the differences.

34. New section 809AZB(3) sets out the default timing rule, which is that the income to be treated as arising in the chargeable period of the transferor in which the transfer takes place. This differs from the corporation tax provision where the default rule is that the income is to be allocated in accordance with GAAP.

35. New section 809AZB(4) and (5) contain a different rule for cases where the relevant receipts would have been taxed as trading income or income from a property business. In cases where consideration is the measure of the income, it is to be treated as arising when it is, in accordance with GAAP, recognised in the transferor’s profit and loss account or income statement. Where market value is used, then the excess over the

consideration is to be treated as arising at the same time that it would have been recognised if consideration equal to full market value had been received.

36. New section 809AZB(6) gives the timing rule where the transferor is a company within the charge to income tax and the rule above would not involve full recognition of the income. In such a case, the amount that would not be recognised is to be treated as arising at the time that it becomes apparent that not all the income would be recognised in an accounting period of the company.

37. The differences here reflect the fact that whereas a company will always produce accounts, a person within the charge to income tax is likely to do so only in relation to taxation of profits from a trade or property business.

38. Paragraph 8 amends CTA by inserting a new Chapter 2B.

39. Paragraph 8(2) adds a reference to new Chapter 2B in the overview part of Part 6.

40. Sub-paragraph (3) inserts new Chapter 2B consisting of new sections 486F and 486G. (Sections 486A to 486E are part of the "disguised interest" legislation.) The two new sections are intended to ensure that the corporate purchaser of the relevant receipts is treated as party to a loan relationship with the result that the company obtains relief, on an accounts basis, for the cost of acquiring the income stream against any receipts arising from the income stream or from a subsequent sale of the income stream.

41. Section 486F gives the case: where there is an income stream transfer to a company under Part 1 or under the income tax equivalent set out in Chapter 5A of Part 15 of ITA (inserted by paragraph 7 of the Schedule). In such a case section 486G of CTA provides that the consideration for the transfer of the right to relevant receipts is to be treated as a money debt which is owed to the transferee by the person who falls to pay the relevant receipts and that the transfer is to be treated as a transaction for the lending of money.

42. This will have the effect that Part 5 of CTA will apply to the consideration and subsequent receipts so that the transferee will be charged to corporation tax only on the profit recognised in its profit and loss account in respect of the relevant receipts.

43. There is no income tax equivalent of paragraph 7 (treatment of transferee). If a transferee liable to income tax acquired an income stream to which either Chapter 5A of Part 13 of ITA or paragraph 1 of the CTA Schedule applies, it will either be a financial trader or will treat the transaction as a discounting transaction within section 381 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

44. Paragraph 9 sets out the repeals made as a consequence of the legislation. The list is the same as the list in the December 2007 consultation document, with the following exceptions:

- the repeals in sections 34 and 99 of ICTA are omitted (and not replaced by a reference to any section in Part 4 CTA 2009);
- the repeal of sections 279 to 281 of ITTOIA is omitted;
- repeals consequential on those repeals are omitted;
- a repeal of a reference to section 730 of ICTA in section 98 of the Taxes Management Act 1970 (TMA) is added;
- a consequential repeal in section 774E of ICTA is added; and
- an amendment is made to section 785ZB of ICTA (inserted into that Act by FA 2008) as a consequence of the repeal of section 785A.

45. Paragraph 10 sets out the commencement rule. The Schedule has effect in relation to transfers on or after 22 April 2009.

Background Note

46. In many cases where a person sells or otherwise disposes of a right to receive income (whether one amount or many) without selling the underlying asset from which the income derives, tax law provides that the sum obtained by the seller is taxed as income rather than as a chargeable gain.

47. This may be the result of case law or of specific statutory provisions, the most important of which are sections 730 (dividends), 775A (annual payments) and 785A (chattel lease rentals) of the Income and Corporation Taxes Act 1988 (ICTA).

48. These statutory rules are not comprehensive. There are also differences and inconsistencies in the way the various provisions work, and disclosures made under Part 7 of the Finance Act 2004 and other information shows that they have been the subject of attempts to avoid their operation.

49. The new legislation sets out a general principle that a lump sum received for the sale or transfer of income stream is subject to tax in the transferor's hands in the same way that the income itself would have been (so there is no possibility of converting income into capital). The rule is subject to a number of exceptions.

50. The new legislation follows two consultation exercises on the use of principles-based drafting to counter avoidance in the areas of financial products. The consultation documents can be accessed at the following references:

- http://www.hm-treasury.gov.uk/d/pbr08_financialproducts_802.pdf
- http://www.hm-treasury.gov.uk/d/consult_financialproductsavoidance061207.pdf