



Modernising the taxation of corporate debt and derivative contracts

Consultation document

Publication date: 6 June 2013

Closing date for comments: 29 August 2013

Subject of this consultation:	This consultation is about modernising the rules governing the taxation of corporate debt (loan relationships) and derivative contracts.
Scope of this consultation:	The consultation will gather views about proposed changes to the structure of the regime and to the detailed rules currently contained in Parts 5, 6 and 7 of the Corporation Tax Act 2009. The Government's aim is to provide simpler and fairer tax treatment, minimising the scope for abuse, reducing uncertainty and improving structural and legislative clarity as well as reducing administrative burdens.
Who should read this:	Companies; representative bodies; tax professionals; accountants and accounting bodies
Duration:	6 June to 29 August 2013.
Lead official:	The lead official is Andy Stewardson (HMRC).
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Additional ways to be involved:	HMRC will welcome discussions with interested parties, and will be establishing a working group as a forum for dialogue with stakeholders. In addition, HMRC will hold an open event on Thursday 27 June 2013; details of this can be found in Chapter 17.
After the consultation:	Proposals will be reviewed in the light of representations received. The Government expects to publish its response to the consultation by the end of 2013 along with draft legislation for inclusion in Finance Bill 2014. Responses to the consultation will form the basis for further consultation on measures to be included in Finance Bill 2015.
Getting to this stage and previous engagement:	The consultation is being carried out in the light of comment received, over a number of years and in a variety of contexts, from businesses and others on the complexity of the loan relationships and derivative contracts rules. The Government is also conscious of the history of tax avoidance associated with these financial instruments.

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1. Executive Summary

General

1.1. The tax regime for loan relationships was originally introduced in 1996, and the derivative contracts rules followed in 2002. Over the years there have been many piecemeal changes to the legislation, arising from changes in commercial practice and accounting standards, and in response to attempts to avoid tax. As a result, the regime has become ever more complex and less coherent.

1.2. The Government therefore intends to review and update the regime to make it simpler and clearer and at the same time more robust against tax avoidance. This consultation is part of that process.

1.3. Changes will be introduced over two years, in 2014 and 2015, with the most significant structural changes in the later year. Measures for 2014 will focus on areas where there is a current risk of tax leakage. Further formal consultation is anticipated next year. In the meantime there will be an open meeting on 27 June 2013 and a working group will be set up as a forum for ongoing detailed discussion.

1.4. The proposals put forward in this document do not represent a wholesale departure from the present approach to the taxation of loans and derivatives; there is no change to the basic principle of providing tax relief for interest payable. However the proposals do include some significant changes to the structure and detailed rules of the current regime. Detailed explanation of the proposals and options being considered are set out in more detail in the following chapters. The main points to be covered by the consultation process are summarised below.

Main proposals

1.5. It is intended to **articulate more clearly** the purpose and scope of the regime, and in particular, to clarify the role to be played by a company's financial statements in identifying and quantifying taxable amounts. Although accountancy will very often give an appropriate outcome for tax purposes, the tax regime will sometimes need to take a different approach, where that is necessary to ensure that the full amount of the profits, gains and losses from loan relationships and derivative contracts are brought into tax. The Government considers that the tax regime should be clearer as to when taxation is to depart from the accounting treatment. (See Chapters 3 and 4).

1.6. The Government is proposing a change to base the loan relationship and derivative contract regimes on **amounts recognised in profit or loss in a company's accounts**, in line with the normal approach to calculating taxable profits. By contrast, the current tax rules recognise amounts appearing anywhere in the accounts. (See Chapter 5).

1.7. There may be merit in **combining the separate regimes for loan relationships and derivative contracts** into a single code to reduce the length of the legislation and eliminate unintended discrepancies. This document makes no firm proposal, but invites views on the extent to which the benefits of amalgamation would justify the inevitable transitional disruption. (See Chapter 6).

1.8. The Government is seeking views on the appropriate tax treatment of **connected party debt and transfers of debt around a group**, and options are presented on these. The general approach is to question the extent to which special rules, departing from the accounting treatment, are necessary. (See Chapters 7 and 8).

1.9. A substantial overhaul of the approach to the **taxation of foreign exchange (forex) and hedging relationships** is proposed. Generally, only forex movements in respect of loans and derivatives held for trading or property business purposes would be taxed or relieved. Other forex movements would only be brought into account in prescribed circumstances, principally in the context of hedging relationships. As a result of this and other proposals put forward in this document, it is envisaged that the Disregard Regulations could be substantially repealed. (See Chapter 10).

1.10. The operation of the **loan relationships and derivative contracts rules in the context of partnerships** is considered in Chapter 9. This part of the consultation runs alongside the separate and more wide-ranging review of two aspects of partnership taxation announced at Budget 2013; a consultation was launched on 21 May¹. Proposals are made with a view to ensuring that the tax outcome from loan relationships and derivative contracts held through a partnership is in line with the result had each corporate partner held the appropriate proportion of the instruments directly. They also address the consequences which follow from this where there is a change in the partners' interests.

1.11. Proposals are made regarding the tax treatment of **restructuring of debt**, in particular where a debt is released in exchange for shares issued by the debtor. At present, where debt is released in these circumstances, the debtor is exempted from tax on the accounting credit

¹ <https://www.gov.uk/government/consultations/a-review-of-two-aspects-of-the-tax-rules-on-partnerships>

arising. It is proposed to link this exemption explicitly to debt releases made in a “corporate rescue” where the debtor is at risk of insolvency.

1.12. The current tax treatment of **compound or “hybrid” instruments**, such as debt which is convertible to equity, and of instruments which include an embedded derivative, is to mirror the accounting approach by treating each component as if it were a separate instrument. As a result of anticipated changes to the accounting for such instruments, many of the special tax rules for particular instruments may become redundant. It is now proposed (in Chapter 12) to repeal a number of these rules so as to simply tax (on an income basis) holders of such instruments on the profits, gains and losses arising.

1.13. The Government is inviting comments on how the relief in respect of increases in the value of **index-linked gilts** attributable to inflation could be better targeted. (See Chapter 12).

1.14. It is proposed that the current rules governing the taxation of corporate investors in certain collective investment schemes which hold primarily debt and derivative-type assets (“**bond funds**”) should be repealed. The purpose of these complex rules is to counter tax avoidance, and the Government proposes to replace them with a more closely-targeted rule, perhaps including a test of purpose, so that only tax-motivated transactions would be affected. Particular rules would however be needed for offshore funds. (See Chapter 13).

1.15. The Government also proposes to repeal the “**corporate streaming**” rules, which prevent exploitation by companies of the rate of tax applicable to authorised investment funds, which has historically been lower than the main rate of corporation tax. Following announcement of changes to the corporation tax rate from 2015, these rules are no longer regarded as necessary. (See Chapter 13).

1.16. Chapter 14 discusses **anti-avoidance provisions**. The Government welcomes comment which will help to develop rules which are effective without impacting unnecessarily on genuine commercial activity where there is no tax-avoidance motivation. Two elements are proposed:

- To replace the existing patchwork of highly specific anti-avoidance rules dealing with aspects of the loan relationships and derivative contracts regime with a single provision covering the whole code to prevent manipulation and exploitation of the rules. This would include a test of purpose and, where it applied, would require a just and reasonable remedy to the arrangements caught.

- To update the current “unallowable purpose” rules to address certain specific areas of doubt or disagreement over their application (including where there is a fungible source of funding and where the tax advantage sought is subject to a contingency, and also to align the operation of the derivative contract and loan relationship rules – see paragraph 14.32 for the detailed proposals).

1.17. Chapter 15 invites comment on the likely impacts on companies and groups of the proposals outlined in this document, in terms of both tax payable and administrative and compliance costs.

2. Introduction

Background

2.1. The Government is committed to a modern, transparent, and efficient tax system, to provide the certainty needed for long-term financial planning and investment. Alongside reforms to increase the competitiveness of the tax system, the Government is also acting to ensure that all businesses pay their fair share in tax. Consistent with these objectives, this consultation document contains proposals to modernise the rules governing the taxation of loan relationships and derivative contracts.

2.2. Since the loan relationship rules were introduced in 1996, a number of factors have necessitated frequent changes to the regime.

- The world of finance has changed substantially, and continues to become more complicated, with more types of financial instrument and more fluid boundaries between debt, equity and derivatives.
- Accountancy standards have also come a long way, and significant changes are also anticipated in the coming years. In particular, the UK Financial Reporting Council has now formally issued two new standards, FRS 101 and FRS 102, which for many companies will replace all of the previous standards under UK generally accepted accounting practice (UK GAAP).
- At the same time, these kinds of financial instrument have featured prominently in tax avoidance schemes seen by HM Revenue and Customs (HMRC). This continues to be the case in spite of frequent legislative changes to prevent specific attempts at avoidance as they have come to light.

2.3. This process of continual piecemeal change has tended to compromise the coherence of the regime as originally conceived, eroding transparency and certainty and introducing complexity and further loopholes. For some time, business leaders and commentators have remarked on the complexity of the current rules for the taxation of loan relationships and derivative contracts. The Office of Tax Simplification has also identified it as an area in which significant simplification may be possible.

2.4. The Government therefore believes substantial benefits exist in taking a more measured and comprehensive look at the structure of the regime as it stands, and at the detailed rules within it. In addition, undertaking a review now will permit an updated regime to

be aligned and co-ordinated with the new accounting rules, which should provide a secure footing for some years. The objective is a redesigned regime, which is:

- efficient and supports growth – by being consistent with a wider corporate tax regime that is competitive and provides business with the confidence to invest and expand;
- certain and predictable in its application – because the structure and detailed rules are clearer;
- easy to comply with and as simple as possible to understand – by making the purpose of the legislation clearer and requiring less ongoing amendment and maintenance; and
- fair– because it provides robust protection against abuse and avoidance.

Scope of the consultation

2.5. These objectives need to be met in the context of users ranging from small companies which use a straightforward loan to fund their business to large and sophisticated financial institutions and multinational groups which use large numbers of complex debt and derivative-based instruments in their business. Changes to accountancy will lead to significant alignment in the treatment of medium and large entities. However, the Financial Reporting Standard for Small Entities (FRSSE) will still be available for certain small entities, so the regime needs to be able to deal with the whole spectrum of possible accounting treatments.

2.6. Furthermore, the rules need to apply both in the context of domestic and cross border financing, and the review may need to take account of wider developments in the tax world. For example, it is expected that the Organisation for Economic Co-operation and Development (OECD) will deliver an Action Plan arising from its “Base Erosion and Profit Shifting” (BEPS) project to G20 Finance ministers in July 2013², which may have implications for the rules on corporate finance.

2.7. This consultation document sets out proposals, or in some cases options; these reflect the Government’s position based on its current understanding. Proposals and preferences should however not necessarily be regarded as fixed; decisions will be taken in the light of representations. The document therefore invites views on the proposals, and seeks information about the potential impact on businesses, in terms of both the tax burden and costs of compliance. Although it contains a number of specific questions, respondents should

² This follows the publication, in March 2013, of the OECD’s report “*Addressing Base Erosion and Profit Shifting*”.

not feel necessarily constrained to restrict their comments to those particular points; more general thoughts on the issues raised are also welcome.

2.8. In particular, the Government would be interested to receive views on the possibility of repealing any parts of the legislation which are seldom used in practice. An example of this might be the exclusion from Part 7 Corporation Tax Act 2009 (CTA 2009) of certain derivatives over shares, as provided for in sections 589 and 591.

2.9. In addition, the Government would welcome comments on any difficulties with the loan relationships and derivative contracts regime which are coming to light, or anticipated, in the context of the introduction of FRS 101, FRS 102 and the proposed changes to IFRS 9.

2.10. This document does not generally raise specific questions about the transition to the updated regime; rather, it focuses on the ultimate form of the regime. However, transitional issues may be significant, and comment is welcome in this area, particularly where transitional difficulties may be so serious as to influence policy decisions.

What is being proposed?

2.11. Later chapters of this document address a wide range of topics, some of which are integral to the overall approach envisaged, and some of which are concerned with matters of detail. Headline proposed changes are summarised below, so that the rest of the document can be read with that context in mind.

Refining the core structure (see Chapter 3). The aim here is to:

- provide a more secure base for the regime by making explicit its overall aim;
- make clear the role of accountancy in determining taxable amounts; and,
- rationalise and set out clearly the exceptional cases where tax treatment departs from the normal default approach.

Basing taxable amounts on accounting profit and loss (see Chapter 5). This approach is intended to align the regime with the general approach to computing profits; and to make it more intuitive, reduce the need for computational adjustments and mitigate some tax volatility.

Combining the loan relationships and derivative contracts regimes (see Chapter 6) with a view to eliminating duplication and ensuring consistency of tax treatments.

Revising the detailed rules (see Chapters 7 to 13), particularly in the areas of connected party debt, intra-group transfers, partnerships, foreign exchange movements and hedging, debt restructuring, and the treatment of bond funds and certain particular types of instrument such as “hybrids” and index-linked gilts.

Introducing an integrated and comprehensive anti-avoidance provision (see Chapter 14), which will fit with the prospective General Anti-Abuse Rule and eliminate gaps arising from the current patchwork of anti-avoidance provisions across the regime. In addition, it is proposed to update the “unallowable purpose” rules currently found in sections 441 and 690 CTA 2009.

2.12. It should be noted that in March 2013 the International Accounting Standards Board (IASB) issued an exposure draft³ setting out proposals for the treatment of impairment losses under IFRS. The changes proposed may have significant implications for the reporting of impaired debt, and therefore for the taxation of loan relationships and money debts, particularly in the financial sector. It is likely that the proposals will result in an acceleration of the recognition of credit losses, in particular upon transition. However, the comment period for the exposure draft remains open, and potential commercial and tax impacts are still being evaluated by businesses and the Government. Accordingly, this document does not address questions arising from the exposure draft. This is, however, an area which may be brought into the consultation process at a later stage.

2.13. It is also possible that future developments may highlight other matters which need to be brought within the consultation at a later stage.

Timetable

2.14. The Government proposes to introduce changes in two stages – in Finance Bill 2014 and Finance Bill 2015. This consultation document sets out the full range of proposals currently envisaged for both stages; it is not restricted to measures for 2014.

2.15. This approach is intended to:

- allow sufficient time for consultation and development of an updated regime which is soundly based and which will remain fit for purpose into the future;
- ensure that changes are consistent and coherent;

³ Exposure Draft ED2013/3 “Financial Instruments: Expected Credit Losses”, published on 7 March 2013 and with a comment period ending on 5 July 2013.

- set out a clear “road map” for reform; and,
- comply with the Government’s commitment to early and continuing engagement on tax changes⁴.

2.16. It is envisaged that the 2014 changes will focus largely on addressing those areas in which opportunities for tax leakage exist. Changes for 2015 will encompass wider reform to the structure of the regime and the detailed rules.

2.17. HMRC expects to undertake further, more detailed, consultation in 2014 on measures scheduled for 2015.

2.18. At present, and subject to consultation responses, the Government has in mind that the measures to be dealt with in Finance Bill 2014 should be as summarised in Box 1 below. This process would follow the normal finance bill cycle, including the publication of draft legislation for comment.

Box 1: Measures proposed for Finance Bill 2014

- Overhauling the detailed rules for companies which are members of a partnership to reduce uncertainty and avoidance risk (see Chapter 9). This strand of work will be taken forward alongside the wider consultation on partnership taxation announced at Budget 2013.
- Overhauling the bond fund rules, which determine whether or not returns from assets held in certain investment funds are treated as arising from loan relationships (see Chapter 13).
- Updating the “unallowable purpose” rule in section 441 CTA2009 (see Chapter 14 from paragraph 14.22).
- Refining the scope of tax exemptions applicable to index-linked gilts in order to reduce the scope for exploitation (see Chapter 12).

Question

Q2.1 *Do you think the proposed timetable is practicable (particularly in terms of what would be achievable for Finance Bill 2014)? If not, how could it be adjusted?*

⁴ See the HM Treasury / HMRC Tax Consultation Framework (March 2011), available at <http://www.hmrc.gov.uk/consultations/tax-consultation-framework.pdf>

3. The framework

Introduction

3.1. Clarity in the basic framework of an updated regime is essential. This chapter considers, and makes proposals about, the conceptual basis for such a framework.

3.2. A soundly based regime needs to be clear about two things:

- First, what is within the scope of the regime? In other words, what are the instruments to which it applies, and what is the subject matter, arising from those instruments, which is to be taxed or relieved under the regime?
- Second, what is the measure of the amounts to be taxed or relieved in any period in respect of the matters within the scope of the regime?

3.3. Nothing in this document is intended substantively to change the effect of the existing definitions of what constitutes a loan relationship or derivative contract⁵, or the nature of what the regime is intended to tax, although that is not to say that there is no scope for refining and clarification.

Purpose and scope of the regime

3.4. The legislation should unequivocally set out the purpose of the regime and the subject matter within its scope. This might be expressed as:

Box 2: Purpose of the loan relationships and derivative contracts regime

To tax or relieve, as the case may be, profits, gains and losses of a company on its loan relationships and derivative contracts.

3.5. It is important to be clear that, although the nature of the subject matter and measurement of the taxable amounts arising from it are closely linked, they are quite distinct questions. An approach which does not clearly define what comes within the scope of the legislation and also explain how to arrive at the amounts to be taken into account, and when, will not be robust and will not provide a firm structural foundation for the detailed rules which are built on the core provisions.

⁵ Except in the specific area of perpetual debt – see Chapter 5, paragraph 5.16.

Subject matter of the regime

3.6. The subject matter to which the regime applies would remain in essence unchanged from the current regime. In line with section 293 CTA 2009, “profits, gains and losses” would cover amounts of both a revenue or capital nature, and would include profits or losses from related transactions. The phrase should also be understood to encompass interest payable and receivable and expenses incurred for the purposes of the relevant instruments, in line with section 307(3) CTA 2009.

3.7. An intention or purpose expressed in this way makes no reference to accountancy, and does not depend upon it. The Government believes that in the vast majority of cases, accountancy will provide an appropriate measure of the item to be taxed or relieved (this is discussed further below). However, this does not address the question of how the existence or otherwise of a taxable or relieviable item within the regime is to be established. In practice, in the great majority of situations, there is likely to be little or no difficulty in simply following the accounts. To take account of the limited number of situations where this is not the case, the Government considers it important that it should be clear that, under the revised regime, accounting treatment will not in the last resort determine whether a taxable item exists.

3.8. The important point here is that whilst the accounts may recognise a credit or debit in respect of a loan relationship or derivative contract, it should not automatically follow that it represents a profit, gain or loss falling within the tax regime. If the credit or debit does not amount to a profit, gain or loss arising from the loan or derivative, it should not be within the scope of the regime and, accordingly, should not be brought into account under the regime. Equally, the absence of an amount recognised in the accounts should not mean that there is no profit, gain or loss arising from the company’s loans and derivatives.

Measurement and timing

3.9. The Government believes that, in the context of the measurement and timing of amounts to be taxed or relieved, the reliance of the current rules on accountancy remains generally, though not universally, appropriate. Chapter 5 considers the main accounting framework for quantifying amounts to be brought into account under the regime.

3.10. , there will inevitably be particular circumstances in which it is necessary to require departures from accounting measures for particular reasons, and a framework for such departures is discussed in paragraphs 3.30 to 3.35 below. On the other hand, and as a separate matter, using accounting entries to determine whether or not a taxable or relieviable item exists in the first place can be problematic; this is discussed further below.

Tax and accountancy

3.11. Identifying the scope of the regime by a method not ultimately governed by accounting treatments is not to imply that accounts give an unrealistic view of a company's overall commercial position, or one that is not "true and fair". However, there are situations where, for example, the accounting treatment in a particular area may not reflect the legal form of certain items of income, or the amounts reflected in the accounts may be impacted by some other instrument or transaction which does not fall within the scope of the loan relationships or derivative contracts regimes. There is further discussion of certain instances of this kind in Chapter 4.

3.12. Such mismatches and tensions between accounting treatments and the intention or application of tax rules may arise as natural and unsought consequences of applying substance-based accounting rules to commercial transactions, but may also be the result of deliberate and abusive manipulation which seeks to exploit interactions between accounting and tax rules. For example, HMRC has seen avoidance schemes under which profits are said to fall out of account for tax purposes, or amounts are claimed as losses, as a result of the derecognition, in accordance with GAAP, of cash flows under a loan relationship or derivative contract.

3.13. In some cases of avoidance, HMRC may challenge the accountancy used by a company; but, if the scope of the regime ultimately rests on and defers to the accounting view, there will be cases in which no successful challenge is possible – for instance where accounting rules have been correctly applied, but the result is nonetheless incompatible with the intention of tax rules.

3.14. As noted earlier, in many of these circumstances, whether or not avoidance is involved, it is not that the accounts are "wrong". Rather it is that particular accounting approaches may present transactions in a way which, for tax purposes, would give a result which does not accord with the purpose of the regime. In other words, the accounting treatment may give an entirely reasonable accounting answer, but it may not be addressing, from the point of view of the loan relationship or derivative contract tax rules, the right question – namely, what are the profits, gains and losses from a particular loan relationship or derivative which fall to be taxed in a given period?

3.15. The regime as it stands does provide for the possibility of GAAP being overridden in some circumstances. Section 307 CTA2009 includes two potentially competing stipulations about the amounts to be brought into account:

- Section 307(2) contains the general rule that the amounts to be brought into account are “*those that are recognised in determining the company’s profit or loss for the period in accordance with generally accepted accounting practice*”.
- Section 307(3) then requires that the amounts brought into account should, taken together, “*fairly represent*” the profits, losses, interest and expenses arising in respect of a company’s loan relationships and related transactions for the period.

3.16. Subsection (6) makes the general requirement of subsection (2) to follow GAAP subordinate to the requirement in subsection (3) to “fairly represent” the profits etc.

3.17. In practice however, the effect of the requirement to “fairly represent” has been, and continues to be, an area of disagreement between HMRC and taxpayers; nor has it provided definitive guidance to the courts. It was, for example, considered in the case of DCC Holdings (UK) Limited. The Court of Appeal sought to resolve the dispute by reference to a consideration of a fair representation of interest⁶. However the Supreme Court, while arriving at a similar conclusion, chose not to rely on that line of reasoning to do so, only noting that the conclusion reached was not incompatible with the “fairly represents” wording.

3.18. The Government believes that an explicit stipulation that the existence of a matter within the regime is not ultimately dependent on accounting treatments would provide a clearer legislative mechanism. It would also ensure that the matters to be taxed within the regime can be determined, where necessary, on its own terms and in accordance with its purpose. In most cases the accounting presentation is in fact likely to match the tax requirement, and no difficulty will arise. The legislation would deal with these points quite separately from the provisions governing the measurement and timing of taxable amounts (where GAAP would determine the default treatment), emphasising that these are discrete areas.

3.19. If accountancy is not to determine the existence of a taxable matter within the regime, two questions arise:

- When must the accounting treatment applied by a company be disregarded or overridden?
- In cases where accountancy is disregarded, what is to be the test for the measure of a taxable matter?

⁶ The precedence rule in section 307(6) CTA2009 did not apply for the periods in question in that case.

3.20. As noted above, interpretation of the requirement to “fairly represent” profits etc continues to provoke disagreement. Much of the difficulty with the interpretation of that phrase lies in the absence of any legislative guidance as to what is to be regarded as “fair”. This is particularly problematic in a regime which draws heavily on companies’ financial statements, and will continue to do so. Since those statements are generally reported on by an auditor as giving a “true and fair” view of a company’s financial position and its profit or loss, a concept of “fairness” in the tax legislation may not provide a clear basis for an alternative outcome, where that is intended for tax purposes. In many cases, the essential point of difficulty is whether or not there is an amount within the scope of section 307(3) – whether, for example, an amount shown in the accounts represents a profit or loss from a loan relationship or derivative contract, and is consequently an amount to be included under the regime.

3.21. It is envisaged that the key to the questions in paragraph 3.19 should be found in the fundamental purpose of the regime expressed in Box 2 at paragraph 3.4 above. In particular, the legislation would make clear that the intention is to tax or relieve the “profits, gains and losses” arising from a loan relationship or derivative contract. These are terms which are familiar in tax contexts and which have been considered by the courts on many occasions.

3.22. In determining the existence of a taxable matter, an accounting treatment would be overlooked where the accounting presentation of the facts would not meet the statutory requirement to tax or relieve the profits, gains and losses from loan relationships or derivative contracts. Guidance on the nature of those profits, gains and losses in which the tax regime is interested, beyond that provided in the detailed provisions of the regime, would if necessary be sought in the body of cases decided by the courts in the past. In concept, this mirrors the approach taken by the general corporation tax code: section 8(3) CTA 2009 requires that *“corporation tax...is assessed and charged on the full amount of profits arising in the accounting period.”*

3.23. The Government would welcome views as to whether this approach would adequately define, in principle, circumstances in which accountancy is not to be followed and, where that is the case, how the existence and amount of a matter within the regime is to be determined. In particular, views are sought on whether a requirement to the effect that amounts brought into account should represent the full amount of the profits, losses and gains from a loan relationship would be adequate, or whether any further qualification of, or addition to, those words would be useful.

3.24. Chapter 4 of this document includes discussion of some particular scenarios in which accounting presentation might not meet the requirement to tax or relieve the profits, gains and losses arising. Chapter 14 contains proposals for dealing with arrangements which seek to

exploit the loan relationships and derivative contracts regime, including situations where a particular accounting treatment forms part of tax avoidance arrangements.

3.25. It is not proposed that the scope of the regime should be defined mechanically through detailed computational provisions. Such an approach is likely to be difficult to apply, susceptible to abuse and counter to the objectives of this review.

Proposed core structure

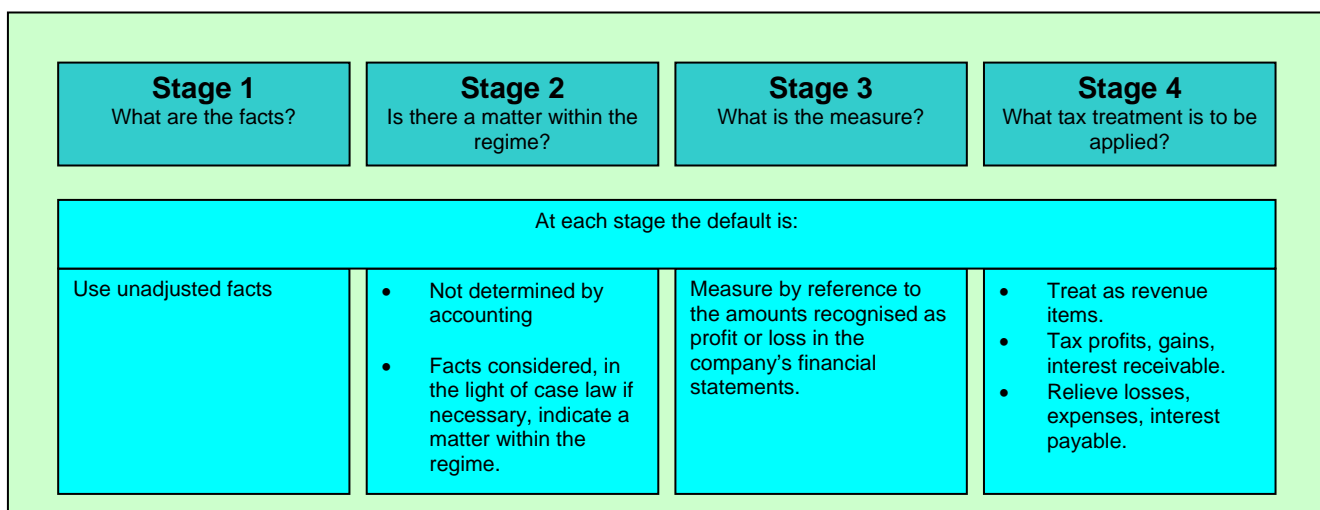
3.26. It is helpful to think of the process of arriving at taxable or relievable amounts under the regime as comprising four stages:

- | | |
|---------|---|
| Stage 1 | Determine the facts of the relevant transactions. |
| Stage 2 | Determine whether, on the basis of the facts, there is a matter which falls within the scope of the regime. |
| Stage 3 | Determine the measure and timing of the item. |
| Stage 4 | Determine and apply the appropriate tax treatment. |

3.27. For the majority of users of the regime this process is straightforward, and none of the four stages is currently likely to pose significant difficulty. For a trading company which simply pays interest on money borrowed to finance its business, or for a company receiving interest on money deposited, no special rules need to operate, and at each of the four stages the default treatments outlined below would apply. Nothing which is proposed in this consultation should produce a different outcome from the current rules in these simple cases.

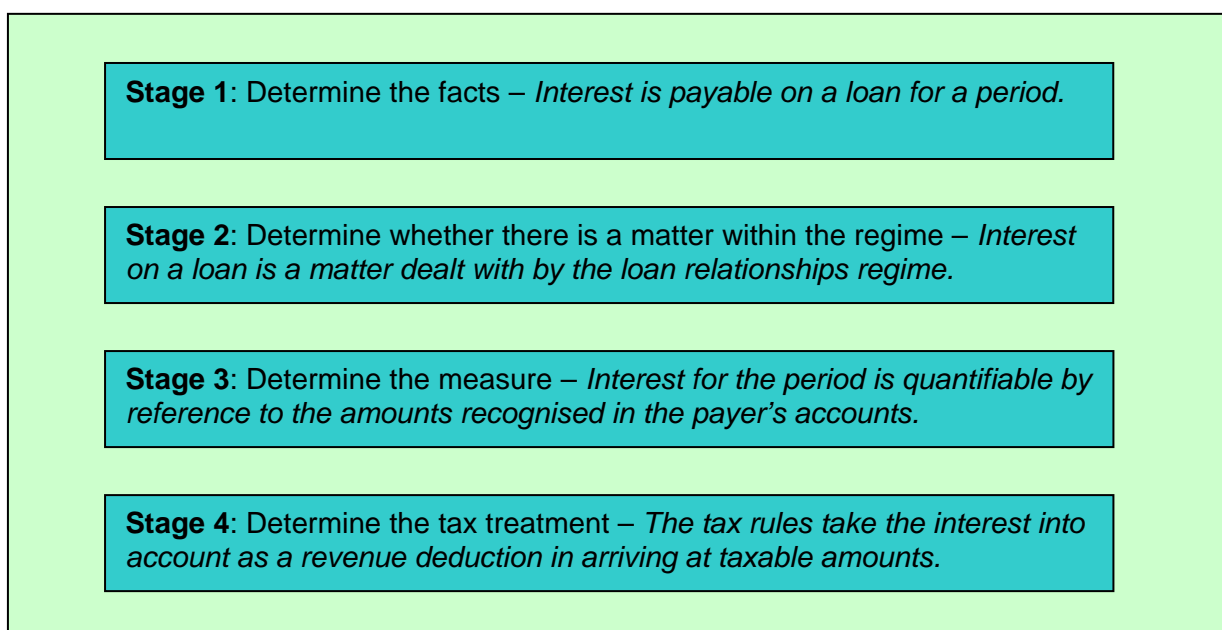
3.28. The default treatments envisaged at each stage can be summarised as:

Figure 1: The default process



3.29. In a simple case such as the first example in paragraph 3.27 above the process would work like this:

Figure 2: The straightforward case



3.30. While that example illustrates the basic “default” approach envisaged, the difficulties with the regime as it stands have generally arisen in areas where such a straightforward process does not apply. It is the agglomeration of particular rules requiring departures from that process which has tended to result in loss of clarity and coherence in the regime. The Government sees merit, where feasible, in reducing the number of rules which seek to depart from the accounts treatment, and several of the proposals in this document should contribute to that aim. However, some departures and specific rules are inevitable and will be necessary to ensure appropriate tax outcomes in situations where there is more factual complexity, a particular policy objective is in view, or there is a need to protect the Exchequer against abuse.

3.31. The Government believes that a coherent and integrated framework, within which rules requiring departure from accounting entries can be set, should be a feature of an updated regime. This might take the form of a categorisation, in generic terms, of the ways in which tax treatments may differ from the default approach. In any case where the legislation requires such a departure, it should be clear into which category that departure falls.

3.32. It is envisaged that such a categorisation could fulfil three purposes:

- First, instances in which specific rules impose a departure from the basic default approach – to tax profits, gains and losses measured on an accounts basis – could be explicitly linked to one of these categories. This would make transparent the context of the particular rule within the overall framework of the regime, and make it easier for users of the legislation to discern the purpose and effect of the rule.
- Second, clarity of structure and purpose would be an important safeguard against attempts to circumvent or manipulate the legislation to achieve unintended outcomes.
- Third, it could enable any new rules which may become necessary in future to be incorporated into the regime without compromising the overall coherence of the legislation.

3.33. The table which follows proposes a series of such categories, which are intended to cover all eventualities.

Figure 3: Categorisation of departures from the default process

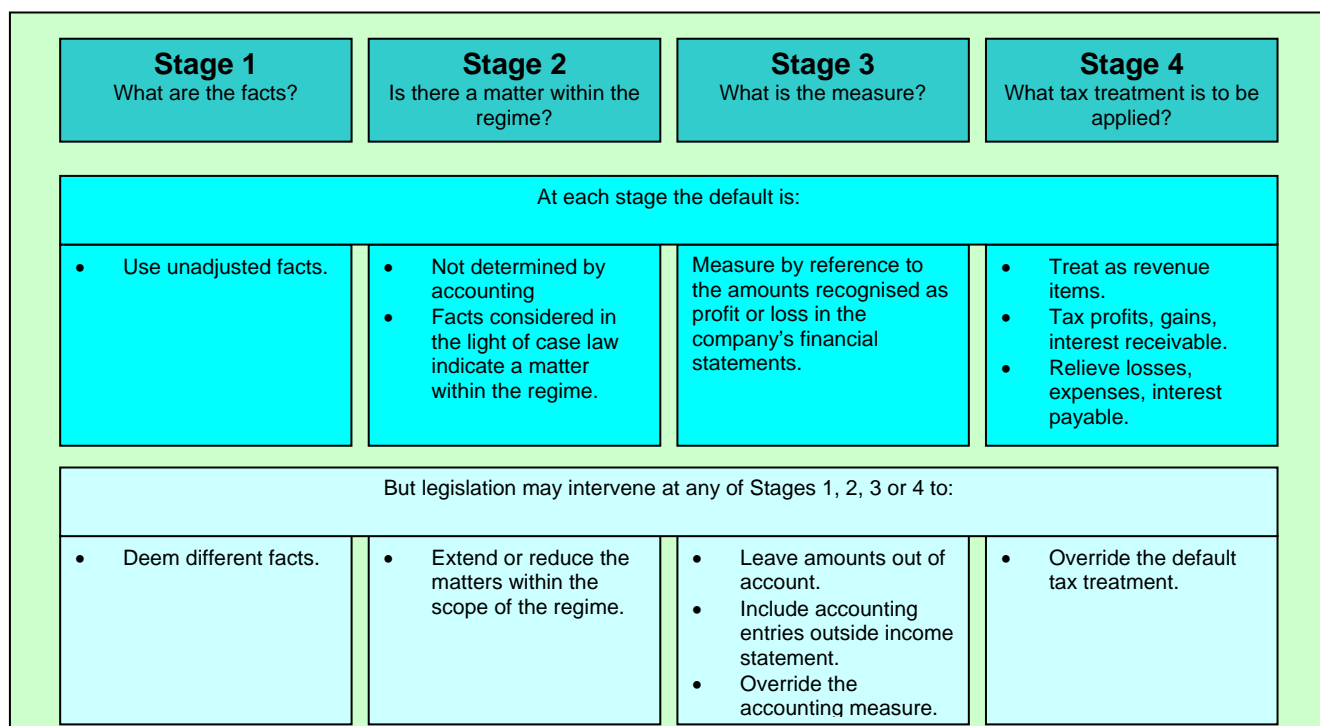
I Deem different facts	II Modify the scope of the regime	III Leave amounts in respect of a matter out of account	IV Take account of accounting entries not in profit and loss	V Override accounting measure	VI Override default 'tax as income' treatment
<p>Deem altered terms of an instrument or transaction. Rules apply to modified facts.</p> <p><i>Examples</i> Transfer pricing</p> <p>Group continuity</p>	<p>Extend or reduce the scope of the regime. Rules apply as normal to the modified scope.</p> <p><i>Examples</i> Pre-loan costs</p> <p>Repos</p> <p>Exclude distributions from the regime</p>	<p>Leave amounts in respect of a matter out of account in whole or part.</p> <p><i>Examples</i> Connected party impairment losses</p> <p>Certain foreign exchange differences</p> <p>Unallowable purpose</p>	<p>Recognise amounts in the accounts not presented in profit and loss.</p> <p><i>Examples</i> Amounts in equity</p> <p>Amounts taken to the carrying value of an asset</p>	<p>Modify accounting measure to bring into account amounts not in accounts. Facts are not modified.</p> <p><i>Examples</i> Amounts not fully recognised</p> <p>Derecognition schemes</p> <p>Change of accounting policy</p>	<p>An amount in respect of a matter is not taxable or is taxed as a non-revenue item.</p> <p><i>Example</i> Items subject to chargeable gains treatment.</p>

3.34. Specific rules may intervene to modify the default approach at any of the stages of the process outlined in Figure 1. Broadly, particular rules falling within category I would operate at stage 1 of the process; rules within category II at stage 2; categories III, IV and V would impact on stage 3, while category VI rules would affect outcomes at stage 4. Figure 4 below illustrates how the default process could be modified by specific rules which address particular situations.

3.35. In cases where the tax rules require the deeming of facts, it will be necessary to adjust the company's accounting entries for tax purposes to reflect the revised facts. When making this adjustment the purposes of the statutory deeming provision and the wider policy of the legislation will need to be taken into account⁷.

⁷ The decision of the Supreme Court in DCC Holdings (UK) Ltd highlighted the need to take account of the "policy of the Act and the purposes of the provisions" in such circumstances.

Figure 4: Potential modifications to the default approach



Questions

- Q3.1** *Do you think the approach outlined in this chapter would provide a secure basis for determining the existence of matters within the scope of the regime and the taxable amounts?*
- Q3.2** *If not, why not and how could the policy intentions be realised?*
- Q3.3** *Would a requirement to the effect that amounts brought into account should represent the full amount of the profits, losses and gains from a loan relationship be adequate, or would any further qualification of, or addition to, those words be useful (see paragraph 3.23)?*
- Q3.4** *Would it be helpful to make the categories set out in Figure 3 explicit in legislation?*
- Q3.5** *Do the categories set out in Figure 3 comprehensively capture the scope of potential departures from the default process?*

4. Looking behind the accounts

4.1. Chapter 3 of this document includes consideration of the role of accountancy in identifying subject matter within the regime and in determining the measure and timing of taxable amounts, while Chapter 5 contains a number of proposals concerned with specific aspects of the interaction between accounting and tax treatments.

4.2. This chapter focuses further on certain situations, referred to in Chapter 3 (see paragraph 3.11) where the treatment of transactions in the accounts might not give an appropriate result for tax purposes. The principal focus here is on the amounts recognised in profit or loss (and hence typically brought into account for tax). However, similar issues arise in the context of the carrying value of loans and derivatives.

Background

4.3. In some circumstances amounts that relate to matters that fall to be taxed under the loan relationships and derivative contracts tax regimes may not be readily visible in a company's accounts, for example because of the impact of some other instrument or transaction that falls outside the scope of those rules. That impact may affect either the amounts appearing in the accounts or where in the accounts an amount is recognised, without affecting its amount. For example:

- The effects of more than one instrument may be combined as if they were a single instrument or vice versa.
- An instrument or amounts relating to an instrument may simply not be recognised.
- An entity may be regarded as opaque for accounting purposes but transparent for tax: amounts relating to loan relationships held via a partnership, for instance, will not in those circumstances feature in the company's own accounts.
- Amounts in respect of a loan relationship or particularly a derivative contract may be recognised in other comprehensive income (OCI) rather than profit or loss, perhaps because of the influence of some other transaction or instrument. In some cases there may be no subsequent reclassification of amounts to profit or loss, or the ultimate reclassification may be to the carrying value of an asset or liability rather than to profit or loss.

- Different tax treatments may be appropriate for amounts that are netted off against each other in the accounts.

4.4. As mentioned in Chapter 3, the issue is not that the accounts are “wrong” and in need of “correction” by tax rules, but rather that the amounts recognised in the accounts or their timing may not be the amounts that would represent the economic consequences of the loan or derivative itself, looked at in isolation.

4.5. Rules are therefore needed to set out when it is appropriate to “look behind” the face of the accounts to “unbundle”, identify and quantify the amounts that relate to loan relationships or derivative contracts and bring them into account for tax.

Policy intention

4.6. Often it may be appropriate simply to follow what is shown in the accounts regardless of the influences that have led to a particular treatment. This is the case, for instance, in most cases where under a cash flow hedge amounts are initially recognised in OCI. Here, in the interests of simplicity, and in order to bring amounts into account for tax that are “right”, from a commercial perspective, adjustments should not be required.

4.7. But in other circumstances a rule will be needed to set out the circumstances, including cases where tax avoidance is a motive, in which it is necessary to look behind the accounts to identify the amounts to be brought into account for tax.

4.8. It is proposed that in principle such a rule should operate where, over the expected life cycle of the arrangements,

- the aggregate amounts to be brought into tax as income items in respect of the company’s loans and derivatives and the other item or transaction, taken together,
- differ materially from the economic profit or loss from those instruments.

It follows that, for example, where amounts outside the scope of the loan relationships and derivative contracts regime fall to be fully taken into account in taxable trade profits, no adjustment might be needed. But in the case of tax avoidance arrangements, for example, this may not be the case, and it would therefore be necessary to look behind the accounts to identify and measure the amounts that should be brought into account under the loan relationship and derivative contracts rules. In the case of tax avoidance, it would also be necessary to unpick accounting treatments aimed at deferring tax.

Problems and issues

4.9. The scenarios set out at paragraph 4.3 are discussed further below in the light of the general approach proposed above.

Composite instruments

4.10. Accounting for more than one legal instrument as a single item was a particular feature of “old” UK GAAP: derivative contracts were often not separately recognised from the instrument which they were hedging. Where, for example, a company used a currency contract to hedge a future transaction so that it could be settled at a particular rate of exchange, SSAP 20 would permit the use of the exchange rate specified in the contract to record the transaction. The derivative itself was not recognised in the accounts.

4.11. Developments in accounting – particularly the recent issue of FRS102 – mean that this approach to accounting should in future become much less common. IAS39, IFRS9 and FRS102 all generally require financial instruments, including derivatives, to be accounted for separately. However, while less common, there are still occasions where composite accounting is permitted or required. HMRC has seen attempts to exploit such accounting aggregation.

4.12. Where there would be a material tax effect, the amounts recognised in the accounts would need to be split between the instruments on a just and reasonable basis. Where amounts have been netted off, the grossed-up amounts would be computed and brought into account for tax.

Derecognition and non-recognition of instruments or related income

4.13. Accounting standards can also allow or require financial instruments to be derecognised in the accounts (“derecognition”). In other cases the accounting standards may allow or require the company not to recognise the loan or derivative to start with (“non-recognition”). These cover a broad spectrum of cases. Where there is a simple disposal, the company will no longer legally be a party to the instrument, and the accounting position will be aligned with the desired tax treatment. On the other hand, in some cases contrived arrangements have been used to derecognise assets or income artificially through, for example, the issue of shares on particular terms so that cash flows are passed on in a form that falls outside the ambit of the loan relationships and derivative contracts tax regime.

4.14. However, these issues may also occur in more benign financial transactions, for instance:

- Sub participation agreements over loan assets.
- Loans acquired under a repo or stock loan transaction, or held as collateral.
- Loans held by a corporate trustee.

4.15. In the first case the transaction will normally involve a financial trader, in which case there may be no reason to disturb the accounting, as the arrangement should have no overall material impact on tax. In the latter two cases, the tax rules normally only seek to tax the recipient company in respect of its beneficial interest in the profits from the instrument.

Differences between the accounting and tax views of an entity

4.16. The entity to be taxed and the entity in whose accounts profits and losses from a loan relationship are reported may be of different types. In particular, certain entities may be treated as transparent for tax but accounted for as a separate investment. This scenario is discussed further in Chapter 9 on partnerships and other transparent entities.

4.17. Equally, an entity may be consolidated into the accounts of the entity to be taxed, but considered a separate person for tax purposes (e.g. an employee benefit trust). In this case it is proposed that it would be appropriate to look through the consolidation and bring the profits and losses from the loan or derivative into account in the company's tax computation.

Profits taken somewhere other than to profit or loss

4.18. In most circumstances accounting standards require items of income or expense from financial instruments to be recognised in profit or loss. However, there are a number of exceptions, some of which reflect the influence of another item or transaction. For example:

- Financing costs may be recognised in the carrying value of an asset – in this case the asset has influenced the accounting for the financial instrument.
- In accounting for a cash flow hedge, certain amounts are initially recognised in OCI, and often subsequently recycled to either profit or loss or to the carrying value of an asset or liability.

4.19. These aspects are discussed further in Chapter 5 dealing with accountancy matters and Chapter 10 which is concerned with hedging and exchange differences.

Net amount recognised in profit and loss account

4.20. Where a net amount is recognised in the accounts in determining the profit or loss for the period it may be necessary to look behind that net amount and to separate it out into its gross components. This is particularly relevant when applying the detailed rules of the regime which require certain departures from the amounts recognised in the accounts. The extent to which it is necessary to split out net amounts in any case will depend on the facts and on the statutory provision concerned. Specific relevant instances seen by HMRC include restrictions under the connected party debt release rules (section 354 CTA 2009), loans held for an unallowable purpose (section 441 CTA 2009) and the treatment of distributions (sections 465 and 1305 CTA 2009).

What is being proposed?

4.21. The central proposal is to make explicit that in certain circumstances tax should not be determined solely by reference to the amounts recognised in a company's financial statements, but instead on the amounts that would be brought into account in respect of loan relationships or derivative contracts if the accounting treatment were not influenced by or bound up with other instruments or transactions.

4.22. Where this approach applied, there would be a general requirement, irrespective of the accounts presentation, to identify, measure and bring into account amounts relating to the matters dealt with under the loan relationships and derivative contracts provisions. This would operate where, over the expected life of the arrangements in question, the cumulative amounts brought into account

- as income in respect of the loan relationships (or derivative contracts) and
- the other instruments or transactions that influenced the amounts recognised in accounts

would be together materially different from the economic profit.

4.23. This should encompass attempted tax avoidance arrangements, but might also have effect if an excessive amount of profit or gain might otherwise be taxed. The impact of such a rule in cases of avoidance is discussed further in Chapter 14.

4.24. The detailed provisions dealing with specific areas of the loan relationships and derivative contracts code would invoke this central proposition where appropriate. This might include, for instance,

- provisions covering tax deferral schemes,
- loans and derivatives held in transparent entities of which a company is a member,
- capitalised interest or “tax recycling” of amounts initially recognised in OCI where there is no reclassification to profit or loss in accounts.

These more detailed provisions are discussed in later chapters of this document.

Questions

Q4.1 *Do you agree with the rule proposed in paragraph 4.21 concerning the identification and measurement of amounts to be taken into account?*

Q4.2 *In what circumstances should such a rule apply?*

Q4.3 *Do you anticipate any particular difficulties with the rule proposed in paragraph 4.21? If so, how might they be addressed?*

Q4.3 *Are there specific circumstances (other than where there is no material impact on tax outcomes) in which such a rule should not apply? If so, what alternative approach could be taken in such cases?*

5. Accounting issues

Background

5.1. The current regime relies heavily on companies' accounts, with the accounting treatment determining, to a large degree, both the amounts taken into account for tax purposes, and the timing. Amounts are brought into account for tax irrespective of where they are recognised in the accounts. This includes items recognised in statements showing items of "profit or loss" (for example, the profit and loss account or income statement) and other statements showing movements in reserves (for example, the statement of total recognised gains and losses or the statement of changes in equity). This differs from the normal approach taken for trade or business profits, which is based on a company's profit before tax, as recognised in profit or loss, without regard to other accounting statements.

5.2. The regime also contains specific rules to deal with the following situations:

- Changes in accounting policy.
- Amounts recognised in the carrying value of certain assets.
- Amounts recognised directly in equity or shareholders funds.

5.3. These rules are described in more detail in HMRC's Corporate Finance Manual at paragraphs 33070 to 33170, 76000, 51070 and 52030 to 52050.

5.4. Changes in accounting standards for financial instruments have a significant impact on the tax rules for loan relationships and derivative contracts. The tax rules were extensively modified in 2004 and 2005 in response to the impact of International Accounting Standards, in particular to accommodate the bifurcation of hybrid instruments and accounting for derivative instruments. There will similarly be significant changes to the accounting position as a consequence of the introduction of FRS 101 and FRS 102, and proposed (but not finally decided) changes expected in IFRS 9.

Policy intention

5.5. The principle of aligning the tax treatment of profits, gains and losses on financial instruments with the accounting treatment, except in specific instances, has been a cornerstone of the regime since its introduction. It remains the intention that, as far as

possible, accounts should provide the means of ensuring that all profits, gains and losses from loan relationships and derivative contracts are brought into account for tax appropriately.

What is being proposed?

5.6. While the “follow the accounts” principle remains a sound approach to determining a company’s profit or loss from its financial instruments (subject to earlier remarks about cases where departure from the accounting result may be appropriate), it has in the past given rise to a number of difficulties, in particular in relation to:

- Amounts recognised in reserves and statements other than profit and loss account;
- Changes of accounting policy; and
- Capitalised amounts.

5.7. Changes are therefore proposed in these three areas. The proposals are summarised below, and the remainder of this chapter then gives further detail. In outline, the proposals are:

- Subject to exceptions, amounts should only be brought into account for tax when they are recognised as profit or loss items in a company’s single entity accounts. Amounts recognised in other comprehensive income (OCI) would not typically be taxed until they were recycled to profit or loss.
- To deal with all changes in accounting policy through a single mechanism.
- To refine the terminology used for dealing with capitalised amounts and designated cash flow hedges.
- It may also be helpful for the legislation to make reference to amounts being recognised “in profit or loss”, rather than to particular performance statements.

Amounts recognised in reserves etc

Current position

5.8. Under the current regime, amounts brought into account for tax include amounts recognised in reserves. This in turn requires specific additional rules, notably the Disregard Regulations⁸, to reverse out certain of those amounts. Examples of this are designated cash

⁸ Statutory Instrument 2004/3256.

flow hedges, exchange movements and certain movements relating to available-for-sale (AFS) assets. In fact, in many cases simply following the income statement or profit and loss account would give an appropriate result.

5.9. Amounts recognised in OCI will normally at some point be “recycled” to profit or loss through a “reclassification adjustment” (to the extent that the amounts have not already reversed); this means that the impact of a shift to taxing items when recognised as profit or loss should be one of timing; the absolute measure of what is ultimately taxed should not generally be affected.

5.10. Companies can account for certain assets at fair value through OCI (as AFS under IAS 39 or through OCI under IFRS 9 proposals). This treatment has the effect of isolating the headline profit figure from the impact of short term market volatility. But the current approach of taxing such amounts in reserves or OCI exposes the tax result to such volatility, creating a mismatch between commercial and tax outcomes and uncertainty for both taxpayers and the Exchequer.

5.11. Further, companies which fair value their own debt are exposed to significant volatility relating to changes in own credit risk from one year to the next. Anticipated changes to IFRS 9 mean that in the future, fair value gains and losses on own credit will in most cases be recognised in OCI, rather than, as now, in the income statement. However, under the current tax rules these fluctuations would continue to be brought into account, retaining the current volatility while creating new discrepancies between commercial and tax results.

Proposals

5.12. It is proposed that amounts recognised in profit or loss should be used as the primary reference point for the measure and timing of taxable amounts under the loan relationship provisions. This would mean that a company’s profit, gains and losses from loan relationships and derivatives would typically be measured by reference to amounts recognised in its profit and loss account or income statement.

5.13. Most items within the scope of the regime which are taken to OCI rather than the income statement will be recycled to profit or loss at a later date, to the extent that they have not already reversed, and hence brought into account for tax purposes at that point. This should generally, over the life of the instrument, provide the correct outcome.

5.14. A long-stop provision may be needed to treat items as recycled from OCI for tax purposes to deal with the situations where there is no GAAP requirement to recycle an

amount which is taxable within the scope of the loan relationship and derivative contract rules. An example would be where this is necessary to ensure that profits in respect of own credit risk were taxed on early redemption of fair valued debt liabilities. It would also be necessary to ensure that the Exchequer was protected against the possibility of profits being artificially recognised in OCI or directly in equity to obtain a tax advantage; this is discussed further in Chapter 14.

5.15. Alongside a move towards measuring taxable amounts by “following the income statement”, there may be merit in revising the terminology employed in the statute to describe the accounting entries to be brought into account, to reflect modern accountancy standards. These often refer to amounts being recognised in “profit or loss” or “other comprehensive income”, rather than making reference to particular performance statements. The tax legislation might therefore be clearer if it used a similarly generic form of words, in cases where a company may not prepare a separate income statement, for example. Views on whether this would be helpful are welcome.

5.16. Certain instruments that currently fall to be taxed as loan relationships or derivative contracts may be accounted for as equity instruments or may display equity-like characteristics. Two particular instances are regulatory capital and perpetual debt instruments.

- **Regulatory Capital:** The Government announced on 26 October 2012 that the coupon on banks’ Tier Two regulatory debt capital would be deductible for tax purposes, and legislation is included in Finance Bill 2013. At Budget 2013 the Government announced that banks’ Additional Tier One debt capital would also be tax deductible. Regulations will be made in the latter half of 2013 under the power at section 221 FA 2012 to prescribe the tax treatment of banks’ Tier Two and Additional Tier One debt capital. The regulations will set out the tax treatment for both issuers and holders of these instruments.

Nothing in this consultation will disturb this approach. Additional Tier One instruments are likely to be accounted for as equity. To ensure that relief is given as intended, the regulations will provide that the coupon is to be brought into account as a loan relationship debit wherever it is recognised. This will ensure that the relief continues to be available irrespective of outcomes from this consultation.

- **Perpetual Instruments:** There are currently no special tax rules for “perpetual instruments” (unless they constitute equity notes under sections 1015 to 1018 CTA 2010), which provide the holder with a right to repayment only on liquidation of the issuer. HMRC has been advised that, although these instruments have the economic substance of share capital, where there is a repayment on liquidation condition, they

legally fall to be treated as debt instruments. It is proposed to make changes to ensure that for tax purposes these instruments do not constitute loan relationships, and that the coupons on them are distributions.

Changes of accounting policy

5.17. The regime currently provides for two separate and alternative approaches for dealing with changes in accounting policy.

5.18. The Government proposes that there should be a single provision dealing with changes in accounting policy based on a comparison between the closing old basis tax-adjusted carrying value and the opening new basis tax-adjusted carrying value (in line with sections 315 to 319 CTA 2009). Where relevant amounts were recognised in OCI, the tax adjusted carrying value would need to reflect the fact that these amounts had not have previously been brought into account for tax purposes.

5.19. It is proposed to make explicit that the provision would apply to changes arising from the different permutations available given the proposed changes to UK GAAP (for example, a change from current UK GAAP to FRS 102, etc).

5.20. Currently most adjustments arising from changes of accounting practice are spread over a period of ten years. This will be reassessed once the impact of proposals under IFRS 9 is clearer, particularly those concerned with the treatment of credit/impairment losses.

5.21. The above reflects proposals made by HMRC in the past⁹.

5.22. Comments are welcome as to whether the same provision should apply where the tax rules require a change to a particular accountancy treatment for tax purposes (for example, the use of amortised cost for connected party debt) This would allow, for example, the rules in sections 350 and 351 CTA 2009 to be repealed or simplified.

Capitalised amounts

5.23. Borrowing costs in respect of the acquisition, construction or production of an asset may be capitalised as part of the cost of the asset. The tax regime currently provides that credits and debits from loan relationships and derivative contracts recognised in the carrying value of a “fixed capital asset or project” are to be brought into account (sections 320 and 604 CTA 2009).

⁹ See HMRC's paper of July 2011 at <http://www.hmrc.gov.uk/ct/loans-derivatives-rules.pdf>

5.24. In addition, where a company has a designated cash flow hedge it may be able to recycle amounts from the cash flow hedging reserve directly to the carrying value of an asset or liability. Regulation 9A of the Disregard Regulations (SI 2004/3256) has a similar, but differently worded, provision. This regulation applies where, under a designated cash flow hedge, amounts are reflected in the carrying value of a hedged asset or liability where “the profit or loss for corporation tax purposes in relation to that asset or liability *“the profit or loss for corporation tax purposes in relation to that asset or liability will not fall to be computed in accordance with generally accepted accounting practice”*”.

5.25. In neither case does the provision apply to amounts reflected in the carrying value of trading stock within Part 3 CTA 2009 or intangible fixed assets within Part 8 CTA 2009.

5.26. No change is proposed to the policy of relieving finance costs capitalised as part of the cost of certain assets. However, as this is an area where there have been different views in the past, comments are welcome on whether there is merit in changing the terminology and aligning the approach adopted by these two provisions to provide greater clarity as to the legislative purpose.

Questions

Q5.1 *Would you support the proposed “follow the profit and loss” approach set out in paragraphs 5.12 to 5.15?*

Q5.2 *Do you anticipate difficulties with a “follow the profit and loss” approach? If so, how might they be addressed?*

Q5.3 *Would you support the proposal to simplify the changes of accounting policy rules so that they are based on tax adjusted carrying value in all cases (see paragraphs 5.17 to 5.21)?*

Q5.4 *Do you anticipate difficulties with the proposed simplification of the change of accounting policy rules? If so, how might they be addressed?*

Q5.5 *Would you support changes to align and clarify the terminology used in the legislation dealing with the treatment of capitalised amounts and the recycling of designated cash flow hedges, and why?*

6. A unified regime for loan relationships and derivative contracts?

Background

6.1. The derivative contracts provisions now in Part 7 CTA 2009, and first enacted in 2002, were modelled on the 1996 loan relationships provisions and have many features in common. This includes the core provisions that base the measurement and timing of taxable amounts on the amounts recognised in a company's single entity accounts. However, some of the provisions are effectively duplicated, appearing in both Part 5 and Part 7 and similarly or identically worded. There are also very similar provisions in both Parts dealing with particular issues, such as EU cross-border reorganisations.

6.2. This consultation provides an opportunity to consider whether it would be simpler and clearer to reduce this duplication by replacing the provisions currently found in Parts 5 and 7 CTA 2009 with a single combined code dealing with the taxation of both loan relationships and derivative contracts.

6.3. Under a combined regime, it is envisaged that the two types of instruments would still have to be defined separately and would have to be treated differently in some respects. Currently, there are some provisions that apply only to loan relationships (particularly where connected parties are concerned); and some special rules apply only to certain derivative contracts (so that, for example, some amounts are treated as capital, rather than income, items). The review of the provisions provides an opportunity to consider whether retention of all of the special regimes is justified and whether there is scope for simplification.

Policy intention

6.4. The overarching objective is that the provisions governing the corporate taxation of loan relationships and derivative contracts should, taken as a whole, be clear, unambiguous and robust, with the minimum of complexity needed to achieve that. There should be consistency of approach to these financial instruments except where there is a policy reason for a difference.

A case for change?

6.5. The main issue with the legislation as it stands is that some provisions are effectively duplicated, appearing in both Part 5 and Part 7 CTA 2009. However the wording is not always identical, leaving room for possible doubt or ambiguity in interpretation. As a minimum

outcome of the review of these provisions, any such differences should be eliminated, ensuring that where the legislation is intended to have identical effect, identical wording is used.

6.6. A combined code could use a single set of machinery provisions, minimising ambiguity and guarding against the possibility that future changes to the legislation might introduce discrepancies. Combination of the codes would also cut down the overall length of the provisions; at present there are 60 or so sections which are “duplicated” in Parts 5 and 7. While brevity may not necessarily be a virtue in itself, eliminating unnecessary duplication should be helpful for users of the statute.

6.7. Commercially, there is often interaction between loan relationships and derivative contracts, particularly in the context of hedging relationships. HMRC has seen certain structures that have sought artificially to exploit the interface between the two regimes. This sort of abuse should be more difficult under a combined regime.

6.8. Equally, in the past there have been instances where tax avoidance arrangements have sought to exploit perceived weaknesses in the loan relationships legislation; once these schemes were blocked, HMRC has seen attempts to develop and extend the abuse to exploit derivative contracts – a second “bite at the cherry”. A unified code should make the legislation more structurally robust and should eliminate the need to duplicate anti-avoidance rules.

6.9. It may be simpler to deal with instruments which are a compound of debt-like and derivative-like elements, such as convertible debt, in a combined code.

6.10. There are significant differences between the existing codes, which might speak against combination. For example, loan relationships are fairly simply defined, whereas the definitions of derivative contracts are longer and more complex. However, there is no obvious reason why a combined code should be able to accommodate differences of this kind.

What is being proposed?

6.11. Combining the codes is not an inherently difficult process, and if starting from a blank piece of paper, a combined code would have clear advantages. The essential question is whether pursuing those advantages would justify the inevitable transitional disruption. The Government’s initial assumption is that a combined code could serve the ends set out in paragraph 2.4 above better than the current arrangements, but a final view will be taken in the light of representations made in consultation.

6.12. Some provisions would continue to have relevance to loan relationships or derivative contracts specifically, so HMRC is not proposing a complete alignment of the provisions of the existing codes. For example, it is expected that a framework for connected party debt would continue to apply for loan relationships only, and would not be extended to include derivative contracts.

6.13. It would therefore probably be necessary, if the codes were combined, to retain the separate concepts of loan relationships and derivative contracts. A collective term such as “financial instrument” might be employed in drafting to make the wording of the legislation less cumbersome where provisions apply identically to loan relationships and derivative contracts.

6.14. As noted earlier, if the codes were not combined, it is envisaged that some amendments would in any case be made to ensure consistency in cases where existing differences in wording between the codes do not reflect any difference in policy intention.

Questions

Q6.1 *What benefits and difficulties would you anticipate from combining the loan relationships and derivative contracts codes into a single body of legislation with shared machinery provisions?*

Q6.2 *How might any difficulties be addressed?*

Q6.3 *Overall, would you support such a change?*

7. Connected party debt

Background

7.1. The current rules on connected parties in Chapters 5 to 8 of Part 5 CTA 2009 are one of the key instances where loan relationships depart from the general “follow the accounts” approach to determining taxable amounts. They are described in more detail in HMRC’s Corporate Finance Manual from paragraph 35000.

7.2. The main features of the connected party rules can be summarised as follows:

- Companies must use the amortised cost basis of accounting for connected party loan relationships.
- No debits or credits are to be brought in for impairment and releases of debt in respect of connected company relationships.
- A ‘deemed release’ is brought in by the debtor company where impaired debt comes to be held between connected companies.
- Interest and discounts may not be deductible in certain circumstances until interest is actually paid or discounted securities are redeemed, where:
 - the debtor company and the creditor company are connected companies;
 - the creditor is a close company participator;
 - the debtor and creditor companies have a major interest in each other;
 - the creditor is an occupational pension scheme.

Policy intention

7.3. Although the rules have undergone a number of changes since 1996, their underlying rationale remains: to prevent the exploitation of asymmetries between the accounting policies of connected companies, in both a domestic and a cross-border context.

7.4. In particular, the rules prevent deductions for impairment losses which could otherwise be available on connected party lending, possibly in addition to any underlying loss. They also prevent multiple deductions for impairment losses on connected party debt where a chain of loans passes through a number of group companies. The late interest rules are aimed at preventing the avoidance of tax through timing and permanent mismatches in the deductibility and taxability of interest payable by debtor companies to a connected party (whether corporate or certain non-corporates).

7.5. The legislation in Part 21B CTA 2010 on group mismatch schemes (introduced in the Finance Act 2011) has reduced the risk to the Exchequer from some connected party asymmetries arising in a group context, but problems remain in a number of areas.

Problems

7.6. Difficulties with the current rules have been encountered in the following areas:

- Any departure from the core concept of following a company's accounting entries imports computational complexity into the regime. While the amortised cost basis is the usual accounting treatment for many companies that are party to straightforward loans, there have been cases where at least one of the connected companies has used fair value accounting. Such mismatches, with the resulting computational complexity, may become more common under IFRS 9 and FRS 102.
- The definition of amortised cost basis for tax purposes does not precisely align with the accounting definition. For example the language used in the statute refers to 'cost', whereas IAS 39 and FRS 26 require amounts to be initially recognised at fair value. In addition, accounting standards permit the carrying value of a financial instrument to be adjusted for the fair value risk in respect of a designated fair value hedge.
- In some instances, for example where there is a fair value hedge of a loan relationship, the combined effect of the connected company rules and the Disregard Regulations is to require computational adjustments where following the accounting entries would give an acceptable answer for tax purposes.
- Connection is not always defined consistently, so that definitions may not be sufficiently robust where a company seeks to escape the consequences of the connected company rules. In addition, while companies may become connected part way through an accounting period, they are treated under section 348(6) CTA 2009 as connected for the whole accounting period.
- Section 352 CTA 2009 prevents the crystallisation of losses (including impairment losses) on the disposal of connected party debt. However, this does not always give consistent results where the debt is redeemed early and there have been fair value movements not relating to the deterioration to credit risk.
- The connected company release rules have in the past been exploited as part of avoidance arrangements, including cases involving the application of the deemed release rules in which groups sought to turn a timing tax advantage into a permanent benefit. Such avoidance resulted in amendments to deemed releases in Finance Acts

2010 and 2012 following Written Ministerial Statements on debt buyback arrangements. Proposals for changes to sections 361 to 362 are discussed in more detail in Chapter 11 on debt reconstructions.

- The interaction of the rules on connected parties and on partnerships, for example in the context of the application of the test of control in section 472 CTA 2009 where companies are subsidiaries of a partnership, can give rise to difficulties.
- The late interest rule is contentious in the context of arrangements which deliberately defer deductibility of interest to an accounting period in which it is more beneficial to the company or its group. At the same time, the anti-avoidance role of the provision in the context of cross-border finance has been substantially curtailed by limiting its application to loans from “non-qualifying territories” (e.g. offshore tax havens).

Options

7.7. The Government has identified two possible options to address the issues described above. These options illustrate a range of possibilities, from minimal change which preserves most features of the current rules, to a more radical approach involving a move away from the statutory fiction of imposing the amortised cost basis in connected company situations. The options should not be regarded as wholly discrete.

Option 1

7.8. Option 1 is broadly to retain the current approach, but make changes to the definition of connection and the tax definition of the amortised cost basis in order to:

- fully align the tax definition with the accounting definition;
- accommodate fair value adjustments in instruments recognised on that basis and which are part of a designated fair value hedge.

7.9. Changes to clarify the operation of section 352 CTA 2009 would also be considered, for example to limit its application to amounts relating to impairment losses and deterioration in creditworthiness.

7.10. Option 1 has the advantage of requiring only minimal changes to familiar legislation and should substantially address the difficulties with designated fair value hedges of connected party debt. However, it does not do away with the need for computational adjustments where a company uses fair value accounting for the loan.

7.11. Nor would it interact entirely satisfactorily with the debt release rules. As a result, an adjustment may be needed to claw back any fair value adjustment previously recognised where there is a designated fair value hedge. The implications of any change to section 352 will also need to be considered. This would add a degree of complexity to the regime.

Option 2

7.12. Option 2 would incorporate the alignment of the definition of amortised cost basis as set out in Option 1, and would retain the principle that impairment and credit losses on connected party debt are not brought into account.

7.13. This option would involve a more extensive overhaul of sections 354 to 359 CTA 2009, including their repeal in so far as they relate to debt releases. This would permit amounts recognised on debt releases to be taxed in accordance with accounting entries. This would largely neutralise the difficulties with debt releases which have been highlighted above under Option 1 and would result in fewer computational adjustments. It would also absolve the deemed release rules from their role in ensuring the debt release rules operate symmetrically. Deemed release rules would, however, still be needed to prevent groups deferring tax on profits that have been realised at group, but not entity, level.

7.14. However, such an approach would potentially expose the Exchequer to some of the risks of asymmetry that the current rules seek to prevent, in particular in relation to releases of debts owed to a UK company where the debtor is a connected company outside the charge to corporation tax. So in place of the current connected party debt release rule, this asymmetry could be directly addressed by, for example:

- requiring an amount representing the fair value of the loan at the time of the release to be treated as non-taxable for the debtor and non-deductible for the creditor;
- reliance on other rules, for example an amended “unallowable purpose” rule, the transfer pricing rules in Part 4 TIOPA 2010, adaptation of the group mismatch rules or a bespoke provision to ensure symmetry between the parties.

Preferred approach

7.15. Subject to consultation, the Government's initial preference is for Option 2.

7.16. It is also proposed to align the operation of sections 348, 350 and 362 so that, where two parties to a loan become connected, the necessary adjustments would be made based on the carrying value of the debt immediately before the time the companies became connected.

7.17. Whichever option is adopted in relation to the rules on impairment, releases and fair value adjustments on instruments held at amortised cost, it is proposed to make changes to the late interest rule. These changes could involve the repeal of sections 374 and 376 CTA 2009, so that connected companies and major interest companies would generally deduct interest in accordance with normal principles. There would still be a need to protect against deliberate tax-motivated manipulation, with mismatches and abuse being addressed by the anti-avoidance provisions discussed in Chapter 14 or, if necessary, by a bespoke anti-avoidance rule.

7.18. Changes to the rules on connection and control where they interact with the use of partnerships will be considered as part of wider changes to the loan relationship rules on partnerships (see chapter 9).

Questions

Q7.1 *Which of the options outlined above do you prefer, and why?*

Q7.2 *Do you anticipate difficulties with Option 2 set out at paragraph 7.12 to 7.14 and, if so, how might they be addressed?*

Q7.3 *Which of the approaches set out in paragraph 7.14 would be preferable?*

Q7.4 *Are there other relevant issues which are not addressed in this chapter and, if so, how would you address them?*

8. Intra-group transfers (group continuity)

Background

8.1. The group continuity rules at Chapter 4 of Part 5 CTA 2009 apply where a company transfers a loan relationship to another company in the same group and both companies are within the charge to corporation tax. Similar rules in Chapter 5 of Part 7 CTA 2009 apply to derivative contracts. The key features of the group continuity rules are as follows.

- The consideration for the transfer is deemed to be the “notional carrying value” (NCV) of the loan relationship in the accounts of the transferor.
- Where companies in the same group are also “connected companies” for the purposes of the loan relationship rules (as will often be the case), the group continuity rules take priority over the connected company rules in Chapter 5 of Part 5 CTA 2009. Because they specify the consideration to be used for tax purposes (the NCV), the group continuity rules, where they apply to a transfer, preclude any need to consider an arm’s length price under either the transfer pricing provisions or the rule in section 444 CTA 2009.
- Transfer at NCV does not apply where the transferor uses fair value accounting. In this case the transferor must bring into account the fair value of the loan relationship, and the transferee company is regarded as acquiring the loan relationship at the same as the amount brought into account by the transferor, less any discount taxed on the transferor.
- The rules provide for a deemed disposal if the transferee company subsequently leaves the group in certain circumstances.
- The group continuity rules do not apply in certain cases of attempted tax avoidance.

8.2. For periods before 16 March 2005 the rule operated in a different way, by treating the transferee company as standing in the shoes of the transferor.

8.3. The term “group” for the purposes of the group continuity rules takes its meaning from section 170 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992).

8.4. HMRC’s guidance on the group continuity rules can be found in the Corporate Finance Manual at paragraphs 34000 and 53000.

Current approach

8.5. Under the current regime, the group continuity rules introduce a departure from the core treatment of loan relationships. They achieve a broadly similar effect to the chargeable gains rules under which assets may be transferred between group companies at no gain/no loss (see section 171 TCGA 1992 and HMRC's guidance in the Capital Gains Manual at paragraph 45300¹⁰). In particular they aim to:

- allow loans and derivatives to be transferred between group companies without tax consequences;
- bring all profits and losses into account over the period during which the loan or derivative is held by companies in the same group;
- counter avoidance arising from the acceleration of losses.

8.6. The group continuity rules also currently interact with the connected party debt rules to ensure that there is symmetry in treatment between the debtor and creditor companies following an intra-group transfer of a loan relationship.

8.7. The current approach can be described as “forward continuity”. The transferee company picks up the tax adjusted carrying value of the transferor, so that the adjusted carrying value is used going forwards. Where the amortised cost basis of accounting is being applied such an approach aligns the tax position with the consolidated group position reported in financial statements.

Problems

8.8. Difficulties have been encountered in the following areas:

- Both the tax concept of NCV and the imposition in certain cases of fair value accounting represent significant potential departures at the company level from the “follow the accounts” principle, adding complexity to the regime and requiring computational adjustments each time a loan relationship is transferred between group companies. Further, it is conceptually and computationally awkward that a taxable profit or loss of one company should be derived from amounts reported by another.
- These problems are compounded by developments in accounting for financial assets and liabilities at amortised cost. In particular, under certain accounting treatments a

¹⁰ HMRC's Capital Gains Manual can be found at <http://www.hmrc.gov.uk/manuals/cgmanual/index.htm>

gain or loss can arise on initial recognition when a company acquires a financial asset or liability, which is clearly not the outcome which the statute envisages.

- One of the aims of the rules is to counter avoidance, but in fact they have themselves proved vulnerable to exploitation, and have also been used to facilitate wider arrangements aimed at obtaining a tax advantage, including, for example:
 - Attempts to create asymmetrical treatment between two companies in respect of the same transaction.
 - Attempts to shift profits and losses between members of a group, or to other groups, including attempts to change the nature of the profit and loss.
- How the group continuity rules operate in the context of partnerships has been an area of dispute between HMRC and some taxpayers. This aspect will be considered as part of the wider changes to the loan relationship and derivative contract rules on partnerships (see chapter 9).

8.9. This consultation is aimed at simplification and reducing opportunities for avoidance. Since the group continuity rules are complex and attract abuse, there is a question whether, in the light of the policy intentions outlined above, special rules in this area continue to be justified, and if so, whether the rules can be made simpler and more robust.

Options

Option 1 – forward continuity

8.10. This option would involve the least change and would keep the current policy intent of permitting groups to transfer loans and derivatives between UK companies without triggering immediate tax charges. The Government would, however, look to amend the rules to:

- a) strengthen the anti-avoidance protection to prevent the group continuity provisions being abused as part of tax avoidance schemes (this could be achieved by the anti-avoidance rule proposed in Chapter 14);
- b) prevent the rules from applying where either the transferor or transferee company applies fair value accounting in respect of the instrument;
- c) clarify the mechanics of the rules so that the initial measurement of the instrument by the transferee company in its tax computations is the NCV; and,
- d) ensure that latent losses as well as latent gains are brought into account where there is a subsequent degrouping.

8.11. However, these changes would not address the conceptual and computational difficulties which arise from taxing the transferee company on amounts which have originally arisen in, and been reported by, the transferor company.

Option 2 – backward continuity

8.12. This approach would be based, broadly, on the rules for certain transfers of business between building societies in Regulation 8 of SI 2009/2971. Instead of the transferee picking up the transferor's carrying value, the transferor is treated as disposing of the loan relationship or derivative contract at the transferee's opening accounting carrying value. This value would be tax-adjusted where particular loan relationship provisions applied to the transferee company in respect of the loan or derivative.

8.13. The approach is simpler administratively than the current rule because it should require no more than one computational adjustment, and reduce the risk of avoidance. However, protection may be needed to counter the acceleration of losses where the amortised cost basis applies, by the transfer of loan relationships whose fair value is less than amortised cost.

8.14. Potentially this could override the transfer pricing rules in respect of the transfer, to reduce the need for computational adjustments. However, if the transfer is not undertaken at fair value the accounting treatment may in any case require the initial measurement of the instrument to be at fair value. The interaction with the transfer pricing rules would need to be considered.

8.15. Backward continuity is therefore likely to trigger a taxable gain or loss on a transfer that is entirely internal to the group, and to that extent it aligns less well with group consolidated accounting. It is also likely to be inconsistent with the rules implementing the EU Mergers Directive 2009/133/EC, which in effect requires forward continuity.

8.16. There may be scope for a modification to Option 2. Any gain or loss arising to the transferor might be spread over the remaining term of the instrument (rather than taxed immediately), with the balance being brought into account when the transferee ceases to be party to the instrument, or the transferee leaves the group, whichever were earliest. This would avoid premature taxation of gain or loss on a purely internal transfer, but would be more complex than a backward continuity option without deferral.

8.17. Under a "backwards continuity" approach, the application of group continuity rules in the context of debt-equity swaps would also need to be considered.

Option 3 – no separate group continuity rule

8.18. “Following the accounts” would be the most straightforward option both legislatively and computationally. Subject to any other overriding tax rule, both transferor and transferee would bring into account amounts in respect of loan relationships and derivative contracts under normal principles.

8.19. As with Option 2, this would typically result in the taxation of gains and losses on the intra-group restructuring of debt. Potentially a deferral mechanism as mentioned under Option 2 could mitigate this, at the cost of some complexity. Again it might be necessary to ensure that the debt restructuring provisions will apply in the context of group restructuring schemes.

8.20. Such an approach potentially exposes the Exchequer to mismatches between amounts brought into account by transferor and the transferee. For example, there have been schemes seeking to exploit the position where shares are issued to acquire the loan or derivative. However, such mismatches typically arise because the accounts of one or both the companies do not reflect the true economics of the transfer from a tax perspective. Where this is part of tax avoidance arrangements, the anti-avoidance rule proposed in Chapter 14 should apply. This would ensure that the transferor company would be taxed on any profit on disposal based on the full value of the consideration received, and the transferee company would typically be entitled to take account of the value of the consideration given. Alternatively, some protection could be achieved by changes to the Group Mismatch Rules in Part 21A CTA 2010.

8.21. Option 3 would eliminate a source of complexity and would be in line with the general “follow the accounts” approach. However, there is merit in each of the options set out above, and no preference is expressed at this stage; the Government intends to take a view in the light of consultation responses and welcomes comment in this area.

Questions

Q8.1 What is your preferred approach, and why?

Q8.2 Do you see any difficulties with any of the options set out and, if so, how might they be addressed?

Q8.3 To what extent does ensuring tax neutrality on intra-group transfers of loan relationships and derivative contracts remain an important commercial consideration?

Q8.4 *How would the changes proposed under each option ease or intensify the burden of complying with group continuity?*

Q8.5 *Are there issues with the group continuity rules not considered in this chapter and, if so, how might they be addressed?*

9. Partnerships and transparent entities

Background

9.1. Partnerships, in a corporate context, are frequently used as a vehicle for commercial activities, but have also been used in a number of areas to facilitate avoidance. Their essential feature is that two or more persons carry on a business in common with a view to profit.

9.2. For tax purposes a partnership is normally not regarded as an entity which is separate and distinct from the partners¹¹. In addition, partnerships are specifically excluded from the standard definition of a company¹². Instead, the tax rules typically look to tax the partners on their shares of the profits of the partnership. This often means that specific computational provisions are needed to deal with partnerships.

9.3. Partnerships can give rise to a particular difficulty for a regime which normally determines taxable amounts by reference to accounting treatment, as is the case for loan relationships and derivative contracts. This is because the accounts of the partners do not in most cases include the profits and losses of the partnership until the point the profits are treated as being distributed to the partners; this conflicts with the normal approach of treating the partnership as transparent for tax purposes.

9.4. There is a further complexity in that the regime taxes, as revenue items, all profits and losses from loan relationships and derivative contracts. It must address not only income allocation issues, but also with disposals by the partnership and transactions between the members, including changes in profit shares, dealt with in the context of chargeable gains in section 59 TCGA 1992 and as explained by HMRC's Statement of Practice D12 (SP D12).

9.5. The loan relationship and derivative contract rules for dealing with partnerships are described in HMRC's Corporate Finance Manual at paragraphs 36000 and 52700.

9.6. As announced at Budget 2013, the Government is consulting separately on some wider aspects of partnerships, including in particular disguised employment through limited liability partnerships (LLPs) and tax advantages resulting from certain arrangements involving allocation of profits and losses between partners. The partnership consultation and this consultation will run in parallel, and it is likely that there will be some read across between

¹¹ See section 1258 CTA 2009.

¹² See section 1121 CTA 2010.

them in particular on the profit allocation issue. This document is of course focused on particular aspects which are specific to the loan relationship and derivative contract regimes.

Policy intention

9.7. The overall aim is that the application of the loan relationships and derivative contracts regimes to partnerships should be consistent and coherent. In particular that:

- a) corporate partners are taxed or obtain relief for their share of profits, gains and losses from loan relationships and derivative contracts held through a partnership;
- b) the main principles of the regime can apply in the context of activities carried on through partnerships in a way which is clear and does not lead to anomalies; and,
- c) a company's tax result should be materially the same whether a loan relationship or derivative contract is held directly or by way of a fractional share in a partnership.

9.8. In essence, amounts brought into account for tax in respect of a loan relationship or derivative contract to which a partnership is a party should match those that would be brought into account if the corporate partners were direct parties to the appropriate proportion of the loan relationship. The effect would be to tax the partners as if they were carrying on part of the business of the partnership on their own account. Thus, the attributes of the partner and any connection between partner and the counterparty to the loan relationship should be taken into account in the same way as if the partner were directly a party to the loan.

9.9. The fact that the essence of partnership is the carrying on of business in common has implications for certain aspects of that business. For instance if partnership and partner have different functional currencies, the taxable amounts should normally be computed as if the loan or derivative were one of a "foreign operation" of the partner, with the same functional currency as the partnership. It should incidentally be noted that, if the proposals for the taxation of exchange gains and losses in Chapter 10 were adopted, this example would be relevant only in the case of a trading partnership.

9.10. Where there are loans or derivatives between a corporate partner and the partnership, then such arrangements should be recognised. As a result, the corporate partner would be taxed both on profits, gains and losses made on its own account and on its share of the profits, gains and losses made through the partnership in which it is a partner.

9.11. Further, the extent of a partner's interest in a loan relationship or derivative contract may change without there being any transaction that would be reflected in the partnership's accounts, for instance on a change of profit or asset sharing ratios. The loan relationships

and derivative contract regime needs properly to accommodate the consequences of such changes, and in a way that does not result in unnecessary complexity.

Problems

9.12. The current regime does deal with partnerships effectively in most cases. However, differing views have been taken of the effect of particular aspects of the loan relationship and derivative contracts rules in the context of partnerships. This creates risk and uncertainty both for business and the Exchequer.

9.13. Specific difficult areas include the following:

- The current regime does explicitly set out the approach for dealing with partnerships in a number of particular areas. However, elsewhere the position is not directly addressed, and the application of the statute therefore requires consideration of general principles of partnership taxation and how they fit with the overall legislative regime. It is in these areas, which include connected party debt, deemed releases and group continuity provisions, that differing interpretations are encountered.
- While there is an underlying rationale to treating each partner as holding a share of the loans and derivatives of the partnership, the mechanism in section 381 CTA 2009 for calculating the profits of the partners treats each one as having done everything done by the partnership, with the partner taxed on a share of the resulting profit or loss. There may be benefit in aligning the mechanics in section 381 better with the underlying rationale.
- Under the current regime there is no explicit mechanism to take account of changes in partnership interests, for example where a new partner is admitted into the partnership, where a partner disposes of a partnership interest or where there is a change to the partnership agreement. This is especially relevant where there is a substantial difference between the accounting book value and fair value of the instrument or where the tax treatment departs from the accounting treatment.
- The current rules look to tax a corporate partner in respect of “its share” of the profits, gains and losses from loans and derivatives held by the partnership. This is determined by reference to the profit sharing ratio for the period. However, the partners have considerable scope to agree between themselves how the profits should be apportioned. This can give rise to anomalies in the tax treatment and the potential for tax avoidance. This point is a wider issue not specific to the taxation of loans and

derivatives, which will form part of the separate review of the manipulation of profit and loss allocations by partnerships to achieve inappropriate tax results.

- In determining whether control exists between two companies, the current rules in section 472 CTA 2009 sometimes (but not always) look to apportion the rights and powers held by the partnership between the partners. This can give rise to anomalies. Furthermore, the application of section 383 is potentially very wide, applying both to loans with the partnership and loans directly between the partners.

Options

Option 1

9.14. Option 1 would be to follow the current regime, but clarify how the rules operate in the context of partnerships for some specific areas, notably connected party debt and group continuity. This is likely also to require elements of options 2 and 3 below.

9.15. The advantage of this approach would be that the treatment of partnerships could be tailored for each area of the regime. However, this would add complexity and could lead to inconsistencies of treatment.

Option 2

9.16. Option 2 would be to continue with the existing basic approach, but to consolidate the rules, which would apply across the regime, in one place.

9.17. The effect of this option would be that each partner would be regarded as being a party to a share of the loans and derivatives held through the partnership. Each partner would also be regarded as undertaking a share of the activities of the partnership (e.g. in the context of underlying activities which are being hedged) and as holding a share of the property, rights and powers (for example, to determine whether control exists). For profits, gains and losses arising solely within the ambit of the partnership business, the starting point for the tax computations would, in effect, be the partnership's GAAP-compliant accounts.

9.18. Where there is a change in partnership shares, each affected partner would be regarded as undertaking a related transaction, based on the accounting book value of the loan or derivative shown in the accounts of the partnership. This would require revisions to the provisions currently in sections 381 to 384, together with the amendment or repeal of sections 385, 467 and 474 CTA 2009.

9.19. This should make the operation of the rules clearer and ensure that the regime operates consistently. In addition, reliance on the accounting value in the partnership's accounts is a simple approach that should minimise computational complexity. It is similar to the approach taken to chargeable gains on partnership assets by SP D12. For most companies it should mean little change in practice. However, it does not address the risk to the Exchequer where there is a change in partnership shares and partnership loans and derivatives are standing at an unrealised gain (or loss). Some protection against this risk may be afforded through the changes proposed under the concurrent wider review of the taxation treatment of partnerships.

9.20. It is not intended to take particular attributes of individual partners into account for assessing the accounting carrying value – it is important that all the partners view the transaction as taking place at the same amount of consideration. However, adjustments to the accounting value may be necessary in certain cases to reflect adjustments which would be made if the partner were a direct party to the loan relationship. Examples would be where the loan or derivative had been derecognised in the accounts of the partnership as part of tax avoidance arrangements. There would need to be some safeguard against the use of partnerships as a mechanism for attempting to avoid, or artificially fall within the ambit of, connected party rules or where amounts have been recognised in OCI.

Option 3

9.21. Option 3 would be largely the same as Option 2, but would also bring into tax the unrealised profits (from the perspective of the partnership) which arise to corporate partners as a result of changes in partnership interests. As a result, where there was a change in the partnership shares, the partners would be treated as acquiring or disposing of part of the loans and derivatives at fair value, rather than using the accounting book value. Adjustments would be required for the partner treated as making the disposal (to bring in an additional gain or loss) and for the partner treated as making the acquisition (to adjust the calculation of profits and losses in future).

9.22. A variation would be to include, as an adjustment to the accounting carrying value, any amounts of consideration passing between partners attributable to the loan or derivative in question.

9.23. This option would protect the Exchequer from partners attempting to avoid tax on unrealised profits through changes in partnership shares. However, it would increase the compliance burden for corporate partners, particularly where there are frequent changes in partnership shares.

Option 4

9.24. Independent of the options set out above, there is a question of whether the basis for ascertaining each partner's share in the partnership's loans and derivatives should be refined.

9.25. The current basis of using the profit share for a period does have its limitations. For example, it does not directly take account of each partner's interests in underlying assets on the dissolution of the partnership. This is particularly relevant for the loan relationships regime, which seeks to tax the profits from the use of capital (in the form of loan finance). However, there is no single concept of partnership share, and any attempt to define more precisely a partner's share at a particular point in time will have its own weaknesses.

9.26. The main alternative to the current approach would be to require partnership shares to be determined "taking all relevant factors into consideration" rather than specifying a mechanical method. HMRC's Capital Gains Manual sets out, at paragraph 27220, a hierarchical list of items to be considered in determining partnership shares and SP D12 explains the significance of those shares. Those factors would include:

- any agreement or other evidence as to how the proceeds from the loan or derivative is to be allocated between the partners;
- any agreement or other evidence as to how capital and income profits are to be shared by the partners;
- anything under the Partnership Act 1890 which governs how capital and income profits are to be shared by the partners.

9.27. This approach would allow for a more realistic appraisal of partnership shares, which would be less subject to annual fluctuations. It would also provide some additional protection against manipulation of profit shares. However, it may create some uncertainty between partners as to their tax position. Furthermore, departing from the normal basis for allocating profits to corporate partners could in itself create a discrepancy between the calculation of profit from loans and derivatives and the calculation of other profits.

Preferred approach

9.28. Subject to consultation responses, the Government's preferred approach is Option 2. This would lead to a significant improvement in the legislative structure of the regime, without, in practice, fundamentally departing from the current approach for most companies. This

therefore seems to combine protection against the main Exchequer risks with the minimum compliance burden for companies.

9.29. There would still be concern about the potential for partnerships to manipulate partners' interests for tax advantage. Outcomes from the wider review of the manipulation of partnership shares are likely to afford some protection. However, there could be merit in adopting treatment in line with Option 3 for certain prescribed circumstances. These might include:

- consideration being passed between partners outside the partnership;
- consideration being passed between the partners through the partnership; and
- arrangements aimed at avoiding a tax charge on such unrealised profits.

9.30. Changes along the lines of Option 4 are not proposed, at least for now. However, this will be assessed further in the light of consultation responses and in conjunction with the wider partnership review.

9.31. The Government believes that a similar methodology may also be needed where loans and derivatives are held through other types of "tax transparent" vehicles. For example, certain foreign entities are treated as transparent for UK tax purposes. In addition, where income from a loan or derivative is held through a trust for the benefit of a company, then for corporation tax purposes the income from the loan or derivative is regarded as accruing to the company directly.

Questions

Q9.1 *Which of the options outlined above would you prefer, and why?*

Q9.2 *Are there particular circumstances where you would see Option 3 as being either appropriate or inappropriate?*

Q9.3 *Are there any types of arrangement, other than foreign entities treated as transparent and trust arrangements, where you consider the partnership approach could or should be adopted?*

Q9.4 *Are there other relevant issues not addressed in this chapter? If so, what are they and how might they be addressed?*

10. Exchange gains and losses and hedging

Background

10.1. The rules on foreign exchange gains and losses (forex) and on hedging are interrelated. They are therefore considered together in this chapter.

10.2. Corporation tax rules on forex and financial instruments were first introduced in FA 1993 and FA 1994 respectively, and thus pre-date the introduction of the loan relationships rules in FA 1996. All three pieces of legislation draw on the same idea of aligning the tax treatment more closely to the accounting treatment. In 2002 the taxation of forex was brought within the loan relationship and derivative contract regime. Further changes were made in 2004 to accommodate the requirements of International Accounting Standards.

10.3. The key features of the current rules can be summarised as follows.

- The tax treatment of forex and hedging instruments, although based on the accounting treatment, is subject to extensive secondary legislation.
- Forex differences are taxed and relieved with other profits and losses on loan relationships and derivative contracts whether companies are party to those instruments for trading or investment purposes, except where amounts are taken to reserves.
- Profits and losses, in particular forex movements, are normally calculated by reference to the company's functional currency. However investment companies can make an election to apply a designated currency in certain circumstances.
- The taxation of derivatives which hedge non-exchange risk follows the accounting treatment, which is typically a fair value basis for such instruments.
- However, there are further rules providing for particular treatment on forex gains and losses and on hedging set out in secondary legislation, in the "Disregard Regulations" (SI 2004/3256), and the Exchange Gains and Losses Bringing into Account (EGLBAGL) Regulations (SI 2002/1970). The effect of these regulations is to:
 - prescribe that certain forex movements are to be left out of account, particularly in the context of hedging of shares, ships and aircraft;

- prescribe the occasions when amounts previously left out of account (either under primary legislation or the Disregard Regulations) can be brought into account in specified circumstances;
- alter the timing of the amounts brought into account in certain cases where a hedging relationship exists.

10.4. A further feature of the present forex rules is that they aim to address the mismatch between tax and accounting where forex risk relating to different functional currencies used by entities in the same group is managed at the consolidated group level.

10.5. The tax rules are described in more detail in the Corporate Finance Manual in paragraphs 57000 (hedging) and 60000 (forex).

Policy intention

10.6. The key policy intentions of the rules on forex and hedging are as follows.

- To ensure that the tax rules for loan relationships and derivative contracts remain appropriate in the changing accounting environment, which should come fully into effect over the next few years.
- To tax and relieve forex movements that arise as a natural consequence of carrying on or financing a company's trade or property business.
- To exclude forex movements arising from the retranslation of a foreign branch or partnership with a functional currency that is different to that of the company.
- Generally to exclude forex movements from tax where these arise from activities which do not amount to a trade or property business. This will commonly be the case where, for example, exchange movements arise on intra-group lending.
- In the context of forex and non-forex risks, to align as far as practicable the tax treatment of amounts arising on hedging instruments and the related hedged items, both in terms of how the amount is to be taxed (if at all) and timing.

Problems

10.7. The current regime is complex. Even where, as is often the case, following the accounting treatment would provide a sensible tax result (for example in the case of designated cash flow hedges), the tax rules often require extensive computational

adjustments, and perhaps the making of elections, which give companies the flexibility of a choice of options but add to complexity and compliance burdens.

10.8. This complexity is exacerbated in cases where the current regime requires connected party debt to be treated as held at amortised cost for tax purposes, with no hedging adjustments permitted. This requires further rules to restore a sensible tax result.

10.9. In spite of this complexity, the rules do not address satisfactorily the full range of situations in which forex differences arise and in which hedging instruments are used, or reduce tax volatility. Particular problem areas are intra-group lending, and the hedging of partnership interests.

10.10. Currently, unless certain elections are made, the rules typically apply not only to designated, but also to “intended” hedges. This is largely because many companies have been able to apply “old” UK GAAP, which allows much more flexibility in dealing with hedges than is allowed under IAS 39 or FRS 26 and does not require companies prospectively to designate hedging relationships. In 2005, when companies were permitted, and in some cases required, to apply IAS 39 or FRS 26 in their single entity accounts, it was considered that the tax system should not discriminate between those companies that were required to apply the new accounting approach and those that were not. Thus an attempt was made, in effect, to preserve old-style UK GAAP for tax. However, the current position is not entirely satisfactory because it can often be difficult accurately to identify intended hedging relationships. Furthermore, with the introduction of FRS101 and FRS102, all UK companies (except those which use the FRSSE) will need to apply principles similar to those in IAS 39 and FRS 26.

10.11. The division of the rules between primary and secondary legislation is confusing.

10.12. The regime has proved vulnerable in the past to avoidance schemes which aimed, for example, to achieve asymmetry so that a forex loss would be tax-effective, whilst a corresponding forex gain would not. Other schemes, now blocked, aimed to exploit tax mismatches, thereby passing exchange and other risk onto the UK Exchequer. In nearly all cases, the avoidance involved companies carrying on non-trading activities.

10.13. The problems associated with fair value accounting are likely to become more prevalent as many more companies (other than those which apply the FRSSE) will be required to account for derivatives at fair value in the light of changes to UK GAAP.

Proposals

General approach for forex – proposal

10.14. There may be significant merit in a radical change of approach in this area. It is proposed that the default position would be to tax forex movements only in respect of financial instruments held for trading or property business purposes. So where a company is a party to a loan relationship or derivative contract for the purposes of its trade or property business, forex gains and losses would, as now, be included in the profits of that business. Forex movements on financial instruments (other than certain hedging instruments, discussed later in this chapter) held for investment purposes would not be brought into account for tax purposes.

10.15. This approach should simplify computations for the majority of companies and reduce the scope for avoidance. It would remove difficulties which may currently arise in areas such as:

- Hedging of other loans and derivatives.
- Lending to an overseas subsidiary in the subsidiary's currency.
- Ineffectiveness in hedges.
- Unintended unhedged ("naked") positions.
- Mismatches arising from differences in functional currency between entities.
- Avoidance arrangements.

10.16. As explained below, making this change would remove any need for particular rules to disregard certain exchange movements for tax – that would be the default approach anyway. Taking into account proposals made elsewhere, it may be possible substantially or wholly to repeal the Disregard Regulations as they apply to forex, along with the designated currency election rules.

10.17. It should also mean that the one-way effect rules could be repealed. Some protection would be needed to prevent abuse (e.g. using exotic currencies or excessive premiums for options without commercial justification), but this could be provided by the anti-avoidance rule proposed in Chapter 14.

10.18. The proposed differential treatment would mean that the distinction between trading and other activities would assume particular significance, as would the method by which forex movements are calculated, for example in the context of options and other exotic financial instruments. Comments on whether this might lead to new difficulties or risks are welcome.

Instruments hedging forex risk

10.19. The general approach outlined above should greatly simplify the tax position where an instrument is hedging forex risk – in the context of non-trading activities, profits and losses would generally be ignored. However, some rules would still be required. In particular, where a company is party to a loan or derivative in the course of non-trading activities, forex movements arising from hedging relationships, including both designated and undesignated hedges, would need to be brought into account in respect of:

- shares, in which case the exchange gains or losses would be taken into account as part of the chargeable gain calculation on disposal of the asset;
- a ship or aircraft that qualifies for capital allowances, in which case there would be a corresponding adjustment to the capital allowances calculation or an equivalent adjustment through the loan relationship regime;
- expenditure to be deducted or income to be taxed, in which case it would be brought into account in the same manner as the income or expenditure.

Hedging instruments – proposal

10.20. The aims set out in paragraph 10.19 could be achieved by legislation, either primary or secondary, focused specifically on forex hedges along the lines of the existing EGLBAGL regulations 1 to 8, which would need to be updated and refined.

10.21. For other, non-forex, hedging relationships, the approach proposed in Chapter 5 – generally to “follow items of profit or loss” in determining amounts brought into account for tax purposes – would eliminate the need for most of the legislation in the Disregard Regulations. Where a company held a derivative as part of a designated hedge, amounts recognised in profit or loss in the accounts (or possibly in amounts recognised in the carrying value of an asset or liability) would form the basis of the taxation of that instrument.

10.22. This approach would have a number of benefits:

- No specific rules would be needed to tax amounts taken to reserves as part of a designated cash flow hedge and later recycled to the income statement.
- It is proposed in Chapter 7 of this document that, in the context of a designated fair value hedge of connected party debt, the existing connected party rules should be relaxed to permit fair value adjustments to be made. If that proposal were adopted, there would be no need for specific rules to adjust the hedging instrument (the derivative contract).
- In most cases, for example in respect of debt instruments and firm commitments to acquire or sell commodities, there should be no need for special rules to deal with designated fair value hedges; tax will simply follow the accounts.
- Once FRS 101 and FRS 102 are in force, old-style UK GAAP will cease to apply, except, for the moment, to small companies: there is little merit in seeking to retain a tax treatment aligned with an accounting approach which is not expected to endure (see paragraph 10.10) and which has led to tax risk and anomalies.
- Overall, this approach would allow for a significant simplification of the legislation, including substantive repeal of the Disregard Regulations and the one-way effect rules. It would reduce the occasions when unexpected amounts of exchange movements are taxed or relieved, and it should significantly reduce the scope for avoidance.

10.23. It should be noted that, where a company has not designated a hedging relationship for accounting purposes, tax would follow the accounts in the normal way. This would typically mean that undesignated hedges would give rise to tax volatility in line with the accounting treatment. Given the developments in accountancy with the introduction of FRS 102 and current proposal under IFRS 9, the Government considers that this should be a less significant issue now than would have been the case when FRS 26 and IAS 39 were introduced in 2004/5.

10.24. The Government has considered whether it might be preferable to align the tax rules for hedges of forex risk with those for other types of hedges. In that case, where a derivative contract is hedging the acquisition, holding or disposal of a particular item, the treatment of the hedging instrument would mirror the treatment of the hedged item.

10.25. That approach is not regarded as a realistic option. It would require much more extensive legislative changes; effectively it would need the EGLBAGL Regulations to be

significantly expanded to deal with non-forex risk. In addition, it would require that where amounts relating to hedges of non-taxable items are recognised in profit or loss, computational adjustments would be needed to strip these amounts out for tax purposes.

10.26. It is also not apparent that this approach is conceptually more coherent. The current approach of the Disregard Regulations of recycling of all fair value movements (other than certain forex items) appears to result in an appropriate treatment in most cases. Furthermore, it is not considered appropriate to exclude non-forex movements relating to the hedging of share investment. This can be contrasted with the position of forex risk which often arises in connection with the retranslation of foreign operations with different functional currencies across a group.

Questions

Q10.1 Do you anticipate difficulties with the proposal to tax forex movements only in respect of instruments held for trading or property business purposes? If so, what are they and how might they be addressed?

Q10.2 Do you anticipate particular difficulties with the proposal for the treatment of hedging instruments and, if so how might they be addressed?

Q10.3 In view of developments in accounting standards, do you anticipate that companies with hedging relationships will generally be able to opt to apply hedge accounting?

Q10.4 Are there other significant issues with the treatment of forex gains and losses and hedging which are not considered in this chapter? If so, what are they and how might they be addressed?

11. Debt restructuring

Background

11.1. The term “debt restructuring” is used in this document to refer to a range of situations in which the parties to a loan relationship rearrange the terms on which debt is held between them. These situations include the release or write off of debt, and may involve transactions for no consideration, in exchange for the issue of new debt on different terms, or in exchange for the issue of shares. Debt restructuring often takes place in the context of financial distress.

11.2. Debt releases can involve both unconnected and connected companies. Where they involve the latter, the tax treatment of debt restructuring is inevitably bound up with the rules on connected parties, which are discussed in Chapter 7. Previously unconnected companies may become connected with each other as a result of debt restructuring.

11.3. This chapter does not deal with the tax treatment of convertible debt and other forms of hybrid instrument, which are discussed in Chapter 12.

11.4. For the purposes of this chapter, the key points for consideration are:

- The application of the exemptions from a loan relationship credit in section 322 CTA 2009 on a release of debt. This includes section 322(4), which applies where the release is in consideration of the issue of ordinary shares by the debtor company. These are referred to below as “debt releases” and are explained in more detail in HMRC’s Corporate Finance Manual at paragraph 33190 onwards.
- The application of the exemptions from the deemed release rules in sections 361A to 361C CTA 2009. These are referred to below as “deemed releases” and are explained in more detail in the Corporate Finance Manual at paragraph 35420 onwards.

11.5. A more limited relief in section 611 CTA 2009 is available on the release of obligations under a derivative contract; this is explained in more detail in the Corporate Finance Manual at paragraph 52060.

Debt releases

11.6. In most cases where debt is released, the core principle that the credits and debits taxable under the loan relationships rules are (subject to any “fairly represents” override) the

amounts recognised in accounts drawn up in accordance with GAAP. The release will give rise to a debit in the creditor company and a credit in the debtor company. Typically, the creditor may have already made a provision for impairment losses, which will have been brought into account as a loan relationship debit.

11.7. Apart from where the connected company rules currently apply, there are relatively few circumstances in which amounts arising on releases are not brought into account. These are as follows:

- Where either the release is part of a statutory insolvency arrangement (section 322(3) or the debtor meets one of the prescribed insolvency conditions (section 322(5)), the creditor continues to bring in debits in respect of the release, but the debtor will not bring into account credits. These rules do not, as far as HMRC is aware, give rise to any particular issues, except in some cases where the parallel connected party provisions in sections 357 and 359 CTA 2009 apply.
- Where the release relates to the write-off of government investments (section 326 CTA 2009), the debtor company is not required to bring in any credit in respect of the release. Again this does not give rise to any issues.
- Where the debt is released in consideration of the issue of shares by the debtor – a debt-equity swap (section 322(4)).

Deemed releases

11.8. Sections 354 and 358 CTA 2009 provide general exclusions in respect of connected company debts respectively for debits in relation to impairments or credits in relation to releases. The provisions now contained in sections 361 and 362 were introduced to prevent groups of companies from sheltering profits on release of debtor loan relationships in circumstances outside the statutory exclusions. These include cases where a different company in the group acquires the creditor's rights at undervalue and then releases the connected debtor, using section 358 to shelter the profits.

11.9. Section 361 and 362 address this by creating a deemed release equal to the amount that would have been brought into account had there been a direct release of the debtor's liability.

Policy intention

Debt releases

11.10. What is now section 322(4) originated in the repeal of references to amounts credited to share premium account, which were specifically excluded from loan relationship credits, as a consequence of changes to accounting standards in 2004-05. Section 322(4) was introduced to replicate the previous exclusion for such credits.

11.11. Although this rule is explicable given the history of the legislation, there is no obvious policy reason, now that an accounting profit on release may be recognised in profit or loss, for there to be a different tax outcome for the debtor whether the release is by means of cash consideration or shares. In the case of cash consideration the circumstances where the credit on release is not brought into account are restricted to distressed situations, whereas there is no such explicit requirement in the case of debt equity swaps. This makes this provision a target for tax planning where a release outside the various insolvency conditions is contemplated. Changes to sections 358 and 361 CTA 2009 have brought the operation of section 322(4) into sharper focus.

11.12. The application of section 322(4) depends on whether the debt release is “in consideration of” shares. The meaning of this phrase is therefore a key issue under the current provisions, and is the subject of an increasing number of non-statutory clearance applications. HMRC’s guidance on this (in the Corporate Finance Manual at paragraphs 33200 to 33205) envisages that the legislation is most likely to be in point in debt-equity swaps in company rescues.

Deemed releases

11.13. Up to 2009, section 361 provided an exemption from the deemed release provisions where the debt had not been held by the new creditor company in a specified period before it was connected to the debtor. This was intended to cater for “white knight” rescues. Groups were able to plan their way into the exemption, and this became an issue during the recent financial crisis when the fair value of the issued debt of solvent businesses was trading at a significant discount to par value. Two Written Ministerial Statements (WMS) were issued in 2009, followed by legislation introducing more targeted exemptions in similar, but not precisely the same, circumstances as those that apply in direct releases.

11.14. Following further exploitation of the provisions, involving a scheme which sought to avoid a charge under section 361 by engineering the operation of section 362 instead, a further WMS was issued in 2012, and subsequent legislation made changes to address weaknesses in section 362 and introducing a targeted anti-avoidance rule.

11.15. Particular reference was made in these WMS to company rescues as cases in which an exemption from a loan relationship credit is appropriate. The statute now contains three limited exemptions (sections 361A to 361C CTA 2009) from amounts being taxed on the deemed release under section 361 CTA 2009.

Problems

11.16. Difficulties with the current rules have arisen in the following areas:

- As noted above, the interaction with the connected company rules has necessitated amendment to sections 358 and 361 CTA 2009 to ensure that indirect debt buybacks, where a debt is acquired by a connected creditor company and subsequently released tax-free, are taxed consistently with direct debt buybacks, which give rise to a loan relationship credit. The exemptions introduced in section 361 do not completely align with those for direct releases and there is no exemption in the case of section 362.
- For the borrower, under International Accounting Standards and UK GAAP (IFRIC 19 and UITF Abstract 47, respectively), a debt-equity swap will typically result in an amount recognised in profit or loss equal to the difference between the carrying amount of the debt in the debtor company and the fair value of the equity issued. This remains the position under FRS 101. The approach taken under FRS 102 is slightly different, but may also result in an amount recognised in profit or loss. Accordingly, without specific exemption, these amounts arising under debt-equity swaps would be taxable. That would not be affected by any move to generally taxing amounts recognised in profit or loss, as proposed in Chapter 5 of this document.
- Unlike the exemptions from the deemed release rules in sections 361A to 361C, there is no explicit requirement for a transaction within section 322(4) to be undertaken at arm's length. However, it is implicit in case law (for example, *Stanton v Drayton Commercial Investment Co Ltd* (55TC286)), that where the issuance of shares is not based on an "agreed value, honestly reached by a bargain at arm's length" it will be vulnerable to challenge.
- HMRC's approach, described in the Corporate Finance Manual at paragraph 33202, is to look at the substance of the transaction as a whole to determine whether a debt release is "in consideration of" the issue of shares. This may be difficult to determine where there are, for example, options attached to the shares.
- It is common for shares issued in a debt-equity swap to be subject to a number of conditions. While nearly all shares other than some fixed rate preference shares will qualify as "ordinary share capital" for the purposes of section 322(4), the existence of

conditions relating to the shares can make it difficult to determine whether the release is “in consideration of” the issue of those shares. This is the case, for example, where some categories of debt are released for low value shares in order to arrive at an agreed ownership structure.

- While not a common problem in the context of the application of section 322(4), the meaning of the term “release” may not be entirely unambiguous. In the case of *Collins v Addies* (65TC190), for example, it was observed that “,,, ‘release’ does not include any transaction which consists of or amounts to a repayment of a loan, even if the transaction, when viewed in isolation, might be said to have the effect of releasing the debtor from his obligation to repay the loan...”.

11.17. Interpretation of the rules essentially depends on an assessment of whether the statute, construed purposively, applies to the transaction undertaken, viewed realistically. As a consequence of these issues and uncertainties, there has been a significant increase in the number of clearance applications made to HMRC on the application of section 322(4) and of sections 361 and 362.

Options

Option 1

11.18. With the goals of simplification, robustness and clarity in mind, there appears to be a good case for the following changes to sections 322, 361 and 362.

- The exemption for the credit arising from a debt-equity swap in section 322(4) would be explicitly related to corporate rescues. It would be broadly remodelled along the lines of the exemption in section 361A for cases where it is reasonable to suppose that one of the insolvency conditions in sections 322(6) and 323 CTA 2009 would be met within a specified period. It would be neutral as to the form of a debt restructuring, and would apply whether or not there is an issue of shares.
- Conditions A and C in section 322 CTA 2009 would be unaffected by the change.
- A similar change would need to be made to the parallel creditor provision in section 356.
- The exemption in s361C may need to be refined or, potentially, repealed completely.
- Further changes could be considered as part of this set of proposals, including:

- an equivalent exemption in section 362 to that in section 361A for corporate rescues;
- an amendment to the change of ownership condition in section 361A to reflect better the requirement that this should reflect control of the debtor company.

11.19. Subject to consultation, Option 1 is the Government's preferred approach.

Option 2

11.20. As an alternative, Option 2 would be to leave section 322(4) in its current form, but with the introduction of an explicit arm's length requirement.

11.21. This would have the advantage of allowing the legislation scope to adapt to changing commercial circumstances, but would not resolve uncertainties such as what constitutes "consideration" in a debt-equity swap, or the meaning of "ordinary shares". It would require continued reliance on HMRC guidance in this area, and would not address the administrative and compliance burden on HMRC and businesses and practitioners from large numbers of clearance applications. It would also leave unclear the legislative purpose of the exemption, making it more difficult to challenge any avoidance that sought to exploit the provision.

11.22. The consequential changes to sections 361A and 362 outlined above would also be considered under this option.

Questions

Q11.1 Do you anticipate difficulties arising from the proposal in paragraph 11.18? If so, what are they and how might they be addressed?

Q11.2 To what extent, and how, could the difficulties listed at paragraph 11.16 be addressed by a recasting of the wording of the exemptions?

Q11.3 Are there other significant issues in this area not addressed in this chapter? If so, what are they and how might they be addressed?

12. Hybrids and “special treatment” instruments

Background

12.1. Chapter 5 refers to two classes of financial instrument whose particular features may make their status as debt or equity ambiguous – regulatory capital and perpetual instruments. This chapter is concerned with some other instruments which display special characteristics, namely:

- Compound instruments, such as convertible loans, that could be analysed into a combination of a debt component and an equity instrument component.
- Loans relationships and derivative contracts where the current rules apply a chargeable gains treatment to a component of the return on the instrument – in particular, the rules in Chapters 7 and 8 of Part 7 CTA 2009.
- Index-linked gilts (these are considered separately in paragraphs 12.26 to 12.29).

12.2. In overview, the current rules mean that:

- Where a loan relationship is separated for accountancy purpose into debt and equity components (often referred to as “bifurcation”), or where there is an embedded derivative, the tax treatment typically mirrors the accounting, each component being taxed as if it were a separate legal instrument.
- Certain derivative contracts are excluded from the regime, notably where the underlying subject matter of the contract consists of shares. Typically such instruments would be taxed on a chargeable gains basis.
- Other derivative contracts are subject to special rules within the regime, so that certain profits and losses are taxed on a chargeable gains basis, either annually or on the exercise of option rights. These rules principally apply in respect of (i) convertible loans; (ii) share-linked instruments; and (iii) property based derivatives.

12.3. HMRC’s guidance on the current tax rules is set out in the Corporate Finance Manual at paragraphs 37600 and 55000.

12.4. As a result of anticipated changes to the accounting for financial instruments discussed below, it is expected that many of the tax rules may become redundant. It is therefore appropriate to consider whether, in the light of these changes and of experience to date, there is scope for simplification.

12.5. The issues raised below need to be addressed whether or not the loan relationships and derivative contracts provisions are combined, as discussed in Chapter 6. However, it is noted that this is currently one of the main areas of difference in the tax treatment of loan relationships and derivative contracts.

Anticipated accountancy changes

12.6. The key relevant accounting changes are:

- Within IFRS, the phased replacement of IAS 39 with IFRS 9 (once finalised).
- Within UK GAAP, the recent publication of FRS 101 and FRS 102, which introduce two new reporting regimes for UK companies.

12.7. Changes to UK GAAP will become mandatory in 2015 when, with the exception of the FRSSE, the existing regime will be withdrawn. However, the eventual mandatory adoption date of IFRS 9 is by no means certain. In both cases there is the possibility of early adoption.

12.8. While all this will result in several possible accounting permutations, it does mean that there will be a significant degree of convergence in the accounting standards overall (except for small companies which apply the FRSSE).

12.9. One likely effect of the replacement of IAS 39 is the removal of the option to account separately for a derivative that is embedded in a financial asset. Instead the whole instrument would be measured at fair value. This is already a feature of sections 11 and 12 of FRS 102 (although in the interim the IAS39 treatment is currently permitted through the IAS 39 option under FRS 102). This evolution in accountancy provides an opportunity for simplification.

Policy intention

12.10. The policy objectives are:

- To ensure that the legislation is capable of accommodating the impact of the impending accounting changes.

- To achieve reasonable consistency of treatment in cases where there may be alternative accounting treatments (normally as a consequence of differences between UK GAAP and IFRS or early adoption of revised accounting standards).
- To eliminate avoidable computational complexity and ensure that the legislation is as clear and simple as is reasonably possible, given the subject matter.
- To remove the scope for arbitrage and avoidance.

Problems

12.11. The main difficulties encountered are as follows:

- The rules introduce an additional layer of complexity within the regime. Within the space of 30 sections, there are effectively 11 separate measures each with detailed conditions, exceptions, definitions and operational provisions.
- It is not clear how often these rules are actually engaged, particularly those covering property based derivatives.
- As noted above, accounting changes are expected to make many of the provisions obsolete.
- We have seen the rules used as part of avoidance arrangements. For example, in the current Finance Bill there is a measure to prevent property based swaps being used to convert capital losses into income losses, with little or no real exposure to the property market.

12.12. The basic question therefore is whether these detailed rules are still necessary, or whether it is sufficient to follow the accounts and tax the resulting amounts as income.

Proposals

Holders of convertible and share-linked instruments

12.13. In the hands of the holder, the current regime taxes many of these instruments, notably convertible and share-linked instruments, as a loan relationship host contract and a separate embedded derivative contract. Typically, the embedded derivative will be subject to the annual chargeable gains regime. As discussed above, in future many of these instruments will be accounted for as one financial instruments held at fair value with no separation of the embedded derivative.

12.14. most cases following the accounting treatment and taxing all profits and losses on these instruments as income will generally give a reasonable treatment for the holder, and this is what is proposed. This is in line with the position previously taken by HMRC in July 2011¹³.

12.15. In cases where there is conversion into shares under such an instrument, it would be necessary to ensure continuity of treatment so that the base cost inherited for chargeable gains purposes reflected the amounts brought into tax as income.

Issuers of convertible and share-linked instruments

12.16. In case of a standard convertible, it will typically still be necessary for the issuer to account separately for the liability and equity components. This is the current position under IAS 32/ In addition, where a company has a designated cash flow hedge it may be able to recycle amounts from the cash flow hedging reserve directly to the carrying value of an asset or liability. Regulation 9A of the Disregard Regulations (SI 2004/3256) has a similar, but differently worded, provision. This regulation applies where, under a designated cash flow hedge, amounts are reflected in the carrying value of a hedged asset or liability where “the profit or loss for corporation tax purposes in relation to that asset or liability 39 and section 22 of FRS 102, and is not expected to change under IFRS 9. The issuer will therefore typically account for the instrument as a combination of a financial liability and an equity component, the measurement of which will be determined at the time of issue.

12.17. In some cases the obligation to issue shares will not meet the definition of an equity instrument. It is anticipated that under IFRS 9 this component would meet the definition of an embedded derivative, which may then be separated out and measured on a fair value basis. Alternatively, for example under section 12 of FRS 102, or as a choice under IAS 39/IFRS 9, the whole instrument could be fair valued through profit or loss.

12.18. It is proposed to continue to treat the two components as separate instruments for tax purposes where this approach is taken in the accounts. The debt component would continue to be taxed as a loan relationship (typically resulting in relief for amounts recognised as the implied financing cost on the financial liability element).

¹³ See <http://www.hmrc.gov.uk/ct/loans-derivatives-rules.pdf> . It was also proposed then to insert a new section 417A CTA2009 to replicate the provision in section 642 in respect of instruments which would have been bifurcated had IAS 39 continued to apply and where the shares would qualify for substantial shareholdings exemption. While this approach remains reasonable from a policy perspective, it would rely on treatment under an accounting standard which is expected to be become largely obsolete over the next few years.

12.19. In the context of standard convertibles (i.e. where the option represents an equity instrument and not an embedded derivative), it is proposed that no amounts are to be brought into account under either the derivative contracts or chargeable gains regimes during the term of the debt.

12.20. In the context of non-standard convertibles and share-linked instruments (i.e. where there is an embedded option which may or may not be accounted for separately), we welcome views as to whether the resulting fair value movements should be taxed as income, as chargeable gains or not taxed at all. While we see that there are merits for each of these, the Government's current preference is to retain the current approach of taxing any gain or loss on cash settlement as a chargeable gain.

12.21. As in the case of holders, where there is a conversion into shares under such an instrument, it would be necessary to ensure continuity of treatment so that the base cost inherited for chargeable gains purposes reflects the amounts brought into tax as income.

12.22. In particular, we note that this treatment does create an inherent asymmetry between the tax treatment of the holder and issuer of a convertible loan note. Views are invited on whether this is likely to give rise to problems or avoidance risks in practice.

Property derivatives

12.23. One further class of derivative contract to which special chargeable gains tax treatment currently applies is those whose underlying subject matter is real estate or a property index. HMRC is not aware of these rules having been used other than in avoidance schemes. It is therefore proposed that these provisions are repealed. However, views are invited on whether these rules are in fact used in any context apart from avoidance and, if so, whether the continuation of such special treatment continues to be appropriate.

Summary

12.24. The effect of the above proposals could allow the repeal of sections 640 to 650 CTA 2009. This would represent a substantial reduction in the complexity of the regime.

12.25. For convenience, the sections of the existing Part 7 CTA 2009 and their origins in Schedule 26 FA 2002 are summarised below, along with outline proposals or comment – views on this are welcome.

Table 1: Summary of Part 7 CTA 2009:

CTA 2009 reference	Sch 26 FA 2002 reference	Application	Outline proposals or comment
Sections 641-642	Para 45A	Annual chargeable gains	Eliminate or retain with much more limited application.
Sections 643-644	Para 45C	Property derivatives	Tax as income as for other derivatives.
Section 645	Para 45D	Holders of convertibles	Accounting developments may render these redundant. Tax holder as income on the entire instrument.
Section 646	Para 45E	Holders of convertibles (pre-determined value)	Accounting developments may render these redundant. Tax holder as income on the entire instrument.
Sections 648-649	Para 45F	Holders of share linked securities	Accounting developments may render these redundant. Tax rules to relate to the entire instrument.
Section 650	Para 45G	Property based total return swaps	Tax as income as for other derivatives.
Sections 652-655	Para 45J	Issuers of certain "non-standard" convertibles	No substantive change is proposed.
Section 656-658	Para 45K	Issuers of share-linked securities	No substantive change is proposed.
Section 660	Para 37	Holding in OEIC, Unit Trust or Offshore Fund	No substantive change is proposed.
Section 661	Para 43A	Contract becomes a derivative contract	No substantive change is proposed.
Section 662	Para 43B	Contract ceases to be a derivative contract	No substantive change is proposed.
Sections 663-664	Para 45B	Carry back of annual CG losses over two years	Accounting developments may render these redundant.
Sections 665-666	Para 45JA	Issuers of standard convertibles	Special rules probably still needed. Possible scope for simplification.

Sections 667-669	Para 45HA	Holders of certain share options	Need for rules to deal with physical delivery of an underlying on the exercise of a derivative contract.
Sections 670-671	Para 45H	Holders of convertibles	
Sections 672-673	Para 45HZA	Holders of share linked securities	

Questions

Q12.1 *Do you agree with the approach proposed in paragraph 12.14 in respect of holders of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?*

Q12.2 *Do you agree with the approach proposed in paragraphs 12.16 to 12.22 in respect of issuers of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?*

Q12.3 *Do you anticipate practical or computational difficulties or tax avoidance risks arising from different approaches to the taxation of holders and issuers, as proposed? If so, how could they be addressed?*

Q12.4 *Are you aware that the property derivative rules are in fact used in any non-avoidance context?*

Q12.5 *Do you support the proposal to repeal the property derivative rules? If not, what would be an alternative approach?*

Index-linked gilts

12.26. A specific area of the loan relationship and derivative contract rules that continues to generate uncertainty and avoidance activity is the taxation of index-linked gilt-edged securities (ILGs). Currently profits, gains and losses arising on ILGs are subject to corporation tax, but any increase in value attributable to inflation is identified and excluded from tax (except, generally, in the case of life insurance companies). This treatment mimics the original capital gains treatment that was available prior to the inception of the loan relationships provisions.

12.27. The intention was, and remains, to exclude from tax inflation-linked adjustments to the carrying value of ILGs which are held for commercial purposes and the holder is economically exposed to the commercial risks of holding the instruments. Originally the relief was only available for ILGs held on non-trading account, but since 2005 it has been generally available to corporate holders of ILGs.

12.28. This relief has in the past been exploited in wholly contrived tax avoidance arrangements, and in December 2009 anti-avoidance provisions were introduced to block a particular scheme which sought to obtain relief where the holder of the ILGs was not economically exposed to actual economic risk. Since then HMRC has continued to see schemes that aim to exploit the relief either through manipulation of the current anti-avoidance provisions or otherwise to produce results at odds with the intentions behind the relief.

12.29. The Government intends to make changes to ensure that its scope cannot extend more widely than intended. That is, the relief should be available where ILGs are held for genuine commercial (not tax avoidance) purposes and where there is exposure to genuine economic risk. This would continue to include ILGs held by companies in the course of carrying on business as a Gilt Edged Market Maker¹⁴ (GEMM). Comment is invited on how this might best be achieved.

Questions

Q12.6 Could a redrafting of the rule currently in section 400 CTA 2009 along purposive or principles-based lines effectively target the relief in respect of increases in value attributable to inflation and prevent abuse?

Q12.7 If not, how could the relief be targeted to provide relief in respect of index-linked gilts held for genuine commercial purposes while eliminating opportunities for abuse?

¹⁴ A Gilt-edged Market Maker is a primary dealer in gilts and actively trades in either conventional gilts, index-linked gilts or both.

13. Bond funds and “corporate streaming”

13.1. This document does not propose major changes to the rules in Part 6 of CTA 2009, which deals with “relationships treated as loan relationships”, except in the case of the “bond fund” rules described below. However, if there are further potential changes to Part 6 which would be beneficial and which would fit within the aims of this review, the Government would be prepared to consider suggestions.

13.2. This chapter contains proposals for changes to legislation in:

- Chapter 3 of Part 6 CTA 2009, referred to as the “bond fund” rules and
- Chapter 3 of Part 4 of the Authorised Investment Funds (Tax) Regulations 2006, referred to as the “corporate streaming” rules.

13.3. Both these sets of provisions are intended to prevent companies liable to the full rate of corporation tax from reducing their tax bill by holding certain types of investment, such as bonds, through collective investment schemes.

Bond fund rules

Background

13.4. The legislation setting out the bond fund rules is in Chapter 3 of Part 6 CTA 2009. There are equivalent rules for derivative contracts in section 587 CTA 2009.

13.5. “Bond fund” is a colloquial term referring to certain types of collective investment scheme - namely authorised investment funds (AIFs), unauthorised unit trusts (UUTs), and offshore funds (OFs) - that invest primarily in debt-type assets. Special rules are needed to deal with entities within the charge to corporation tax that have holdings in such funds to ensure that the investment returns are taxed appropriately.

13.6. This is because a company which invests directly in interest-bearing and similar assets will typically be taxed year by year under the loan relationship rules on increases in value, calculated on an amortised cost or fair value basis. If, on the other hand, such investments are packaged in an “envelope”, such as an offshore fund, tax could be deferred until redemption or sale of units in the fund; potentially the investments may not be taxed as income at all. The bond fund rules counter such arrangements by taxing, on a fair value basis, the units in the funds as if they were loan relationships. They also address the risk that

a corporate investor could otherwise avoid tax on interest distributions by selling their investment shortly before a distribution date.

13.7. If a company invests in an AIF, UUT or OF, more than 60% of whose investments are, at any time in an accounting period of the investor, “qualifying assets” as defined in section 494 CTA 2009 (essentially debt and derivative-type assets), then the investing company’s holding is treated as if it were a creditor loan relationship of the company. An investment vehicle which exceeds the 60% limit is a bond fund.

Difficulties with the bond fund rules

13.8. The rules are complex. It can also be difficult for investors to know whether a fund in which they have invested has breached the 60% threshold in a period.

13.9. The purpose of the rules is to counter tax avoidance. However, they have themselves been extensively exploited in avoidance schemes, often by groups in the financial sector and involving large amounts of tax. Schemes have been designed to bring the arrangements in question within the scope of the rules, in order to exploit the fair value basis of taxation, either as an end in itself or as part of more complex avoidance.

13.10. A fund intended to invest in equities might move into bonds for a short period in response to market conditions. Corporation tax payers invested in the fund would then be subject to the loan relationships legislation for their entire accounting period, and the complex rules applying when a fund becomes or ceases to be a bond fund would then be engaged.

Corporate streaming legislation

Background

13.11. The legislation on corporate streaming is in Part 4 of SI 2006/964 (Authorised Investment Funds (Tax) Regulations) (“the AIF Regulations”).

13.12. The effect of the corporate streaming rules is to counter the possibility that a corporate taxpayer could, by investing indirectly in assets such as loans through an AIF, pay tax on the investment returns at a lower rate than a company which invested directly in the same underlying assets. This is because AIFs pay corporation tax at a rate equal to the basic rate of income tax. Without the rules, where an AIF distributes its interest or other income in the form of a dividend, exempt in the hands of a corporate recipient, tax would effectively be suffered on the interest at 20% rather than at the historically higher full corporation tax rate.

How the corporate streaming legislation works

13.13. The legislation provides special treatment for dividend distributions in the hands of investors in AIFs where the investor is within the charge to corporation tax.

13.14. The total amount available for income allocation must be allocated either for distribution as yearly interest or for distribution as dividends. The main effects of the corporate streaming legislation can be summarised as follows:

- Where the income is distributed as a dividend, it is treated as a dividend on shares.
- Such a distribution would on first principles constitute franked investment income, which is not normally taxable in the hands of a corporate recipient; but where the AIF distributes income to a corporate investor, the corporate streaming provisions in regulations 48 to 52 apply.
- Regulation 48 has the effect of dividing the distribution between its “franked” and “unfranked” parts depending on the nature of the AIF’s investment income from which the distribution was derived. The unfranked part of the distribution is taxed on the corporate investor as an annual payment, which is treated as being received after the deduction of tax at a rate equal to the basic rate of income tax.

Difficulties with the corporate streaming rules

13.15. Like the bond fund rules, the corporate streaming rules are complex and have been exploited in avoidance schemes.

13.16. Such schemes typically seek to exploit the fact that under certain circumstances credit is given for tax supposedly paid by the AIF on the underlying income referable to the unfranked element of distributions. They may then set out to ensure, by various means, that no tax is actually suffered by the AIF on the underlying income and/or by the investor on the gross amount of the annual payment. In cases where the investing company has no liability to corporation tax, it may claim repayment of the deemed credit, regardless of whether the AIF has in fact paid tax or not.

13.17. HMRC has challenged these schemes, and in some instances there have been changes to put the effect of the law beyond doubt in the case of particular arrangements. This has added to complexity and in some instances led to further avoidance schemes intended to exploit the revised rules.

13.18. Apart from contrived avoidance arrangements, the rules often have the effect of giving credit for tax that the AIF has not in fact paid, because its unfranked income is covered by management expenses.

13.19. The reducing differential between the main rate of corporation tax and the rate for AIFs has lessened the need for complex legislation to prevent arbitrage between those rates. Most recently, a single 20% corporation tax rate from 2015 was announced at Budget this year. In principle, this ought to remove the need for corporate streaming rules altogether; however, there are factors that may need to be taken into account, including any potential commercial effects and the possibility of future changes to either the main corporation tax rate or the rate applicable to AIFs.

Proposals – Bond fund rules

Summary of proposals

13.20. The current bond fund rules have no impact on the great majority of corporate taxpayers, but as mentioned above, for those companies which are affected, they are complex and cause difficulties. The broad proposal is therefore that they should be replaced with more closely targeted anti-avoidance provisions, with the aim of simplifying the rules while ensuring protection against exploitation.

Proposed changes for holdings in AIFs and UUTs

13.21. Some of the issues that the bond fund rules were originally intended to resolve have been addressed, at least partially, by developments in accounting practice and changes to the taxation of AIFs and UUTs, and of investors (including corporates) in those funds.

13.22. For corporate investors returns from debt-type assets are largely effectively taxed at similar rates whether held through AIFs and UUTs or directly.

13.23. It is therefore proposed, subject to consultation, that the current rules in Chapter 3 of Part 6 CTA 2009 should be repealed. However, certain additional rules may be needed to address specific points. These issues are explained below.

13.24. There may be potential risk to the Exchequer associated with this approach, and comments are invited on how significant that risk is likely to be. In particular:

- The Government believes that, in the context of AIFs and UUTs (OFs are considered separately below), the main effect of repealing the rules would be that year on year

movements in the fair value of debt assets (that is, changes to the market pricing of such instruments) would not be taxed because such capital profits are exempt in the hands of AIFs and exempt UUTs. The relevant Statement of Recommended Practice (SORP)¹⁵ for AIFs requires the use of the effective interest method, which captures much of the capital return on debt assets, but that would not include gains arising from changes in fair value; the principles of the SORP will, as a result a current review of the tax rules, also apply to UUTs. However over a long cycle, this may not be significant as there are likely to be as many losses as gains.

- A company might buy or sell an interest in an AIF just before a distribution date, and so convert income into capital. Potentially, the disguised interest rules in Chapter 2A of Part 6 CTA 2009 could apply in some circumstances.
- A company might acquire units just before an interest distribution. It would then be taxed on the entirety of the distribution, even though its actual profit was the difference between the distribution receivable and the amount paid to acquire the right to the distribution.

AIFs and UUTs controlled by a single investor or small group of investors

13.25. Disclosed tax avoidance schemes involving bond funds have invariably made use of funds under the control of a single, or very few, investors, usually in the financial sector. To protect against possible attempts to exploit a repeal of the bond fund rules, it is proposed to introduce a targeted anti-avoidance provision.

13.26. Specifically, the Government is considering a rule aimed at arrangements where a corporate investor, either alone or together with others, controls an AIF or UUT. In appropriate circumstances, the corporate investors could be taxed differently, in a way which reflected the underlying returns. This might be on a “just and reasonable” or a “look through” basis (perhaps along the lines of the approach to the taxation of partnerships).

13.27. This might be combined with a purpose test, so that only tax-motivated transactions were caught. Consideration would have to be given to the interaction of such a rule with the regime targeted anti-avoidance rule proposed in Chapter 14.

¹⁵ SORPs are recommendations on accounting practices. They supplement accounting standards in the light of special factors arising in specialised industries or sectors. The reference here is to the Investment Management Association SORP of October 2010.

Questions

Q13.1 Overall, would you support the proposed reform of the bond fund rules in Chapter 3 of Part 6 CTA 2009, and why?

Q13.2 How significant are the risks mentioned in paragraph 13.24 and how could they be mitigated?

Q13.3 Would the proposed reform of the bond fund rules involve other risks to the Exchequer or to taxpayers? If so, how could they be mitigated?

Q13.4 Do you think the anti-avoidance rules proposed in paragraphs 13.25 to 13.27 are necessary and appropriate? Is there a better approach to preventing exploitation of bond funds for tax purposes?

Proposed changes for holdings in offshore funds

13.28. The situation for OFs is different because the UK has no taxing rights over the funds themselves. As OFs are not generally within the charge to UK tax, in the absence of the bond fund rules interest returns could effectively be received by a corporate investor without any tax being suffered (where an actual distribution or reported income was exempt). Notwithstanding the proposed reform of the current rules in Chapter 3 of Part 6 CTA 2009, some provision will be needed in respect of OFs.

13.29. Specifically, the following issues would need to be addressed:

- Offshore funds receiving interest and distributing it as (or, in the case of reporting funds, reporting it as) exempt dividends;
- Non-reporting offshore funds that roll up interest income so that corporate investors are only charged to corporation tax on offshore income gains on disposal.

13.30. With regard to the first issue, it is proposed that a provision similar to that in section 378A ITTOIA 2005 should be introduced for corporate investors. The effect would be that where an OF failed to meet the qualifying investments test (i.e. debt-type assets exceed 60% of the total value) at any time during its period of account then any actual distribution or reported income would be taxed as an interest distribution.

13.31. This proposal would not eliminate the problem of determining whether or not an OF is a bond fund at any time during a corporate investor's accounting period.

13.32. In practice this may not be a major problem for a corporate investor with a significant holding in such a fund. It appears unlikely that there would be a significant number of corporate investors holding investments in OFs and unaware of the nature of the fund's assets to the extent that it would not be clear whether or not the debt assets exceeded 60%. It is however possible that in some cases there could be difficulties in obtaining the necessary information to determine the correct treatment for UK tax purposes.

13.33. With regard to the second issue identified in paragraph 13.29 (offshore funds that are non-reporting roll-up debt funds), the Government invites comments on the extent to which this would result in any deferral or loss of tax.

Questions

Q13.5 Overall, would you support replacement of the current rules in Part 6 of CTA 2009 as they apply to holdings in offshore funds with rules similar to those in section 378A ITTOIA?

Q13.6 Would the introduction of such rules lead to serious practical difficulties for taxpayers or HMRC? If so, how might they be mitigated?

Q13.7 What would you expect to be the extent of any deferral or loss of tax arising from the rolling up of interest in OFs?

Particular types of company

Controlled foreign companies

13.34. Sections 371BG (7) and (8) of TIOPA 2010 reduce a CFC charge where it arises from a relevant interest in a CFC that falls within the definition of a bond fund. This reduction is needed in order to prevent double taxation.

13.35. In considering reform of the rules in Part 6 CTA 2009, the interaction between the taxation of funds and the CFC rules will need to be considered in order to monitor the extent to which any double taxation does or does not arise.

Life Insurance Companies

13.36. Life insurance companies, which are major investors in bond funds, are taxed under a unique regime. The long-term insurance business of a life company is deemed to fall into two categories: "basic life assurance and general annuity business" (BLAGAB) and "other long-term business" (often referred to as non-BLAGAB business). For tax purposes it is treated as carrying on two separate businesses in respect of these categories, and the basis of taxation

is different for each. Profits of the non-BLAGAB business are charged to corporation tax as profits of a trade under section 35 CTA2009 – the normal basis of taxation for a trading company. Profits from BLAGAB business, however are charged to corporation tax under the “income minus expenses” (I - E) basis set out in Chapter 3 of Part 2 FA 2012.

13.37. The I - E basis, unique to life companies, is designed to ensure that the corporation tax charge arising on BLAGAB business encompasses not only profits of the shareholders of the company but also investment returns (income and gains) accruing to BLAGAB policyholders as they arise. Gains and losses on relevant assets forming part of the BLAGAB business are calculated on a capital gains basis and included in the I - E tax computation. Where the life company invests in certain collective investment schemes (namely, authorised unit trusts (AUT) - a form of AIF - OFs or real estate investment trusts), section 212 Taxation of Chargeable Gains Act 1992 provides for a deemed disposal at the end of each accounting period of the company. Such deemed disposals are included in the BLAGAB chargeable gains of the life company and thus taxed under the I - E regime.

13.38. Where an investment of the BLAGAB business falls within the bond fund rules (and is thus treated as a creditor loan relationship), it may also fall within the scope of section 212 (as an OF or AUT); in such a case the bond fund rules would currently take precedence. If the bond fund rules were repealed, however, gains and losses on the value of such an investment would continue to be taxed annually, but as chargeable gains rather than as loan relationships. UUTs however do not currently fall within the scope of section 212, and gains on bond funds which are UUTs would therefore only be taxed on disposal of the holding.

13.39. For bond fund investments of a life company’s non-BLAGAB business, the Government believes the impact of repealing the bond fund rules would be in line with the effect on financial trading companies generally. The asset is likely to be held at fair value, with value movements being recognised in profit and loss and taxed in each period, while income, whether distributed as interest or dividends would equally be taxed as part of trading profits.

13.40. The interaction of the bond fund rules and the specific corporate tax regime for life companies is complex, and it will be important to understand the particular impacts of the proposals above on that sector. The Government therefore invites comment on this.

Questions

Q13.8 What would be the commercial or tax effects on life companies of the proposals above in respect of bond funds?

Q13.9 *If it is anticipated that the proposals would cause particular difficulties for life companies, what are they and how might they be mitigated?*

Options - Corporate streaming rules

Option 1

13.41. As noted earlier, the rationale behind the corporate streaming rules has weakened as the main rate of corporation tax has become more closely aligned with the rate applicable to AIFs, and will disappear entirely from 2015 once the rates are matched.

13.42. Clearly, therefore, one option is simply to abolish the corporate streaming rules. This approach would have clear simplification benefits, and would largely deal with the difficulties referred to earlier in this chapter. Distributions from AIFs would be received by a corporate investor in the form of an exempt dividend with no tax credit attached. Assuming that the AIF paid tax at 20%, the income from the assets underlying the company's investment would be subject to an effective rate of tax equivalent to the main corporation tax rate which would have applied had the investment been made directly, consistent with the policy aim. In the case of an investing company with no liability to corporation tax, no repayment of credit would arise.

13.43. The analysis in the previous paragraph holds good as long as the tax rate applicable to AIFs and the main corporation tax rate are aligned. Repeal of the corporate streaming rules therefore appears to be an attractive option, as long as that alignment continues, or any divergence is small.

13.44. Subject to consultation, this is the Government's preferred option. It is clearly in line with the general simplification objectives of this review, and there is no reason to expect that future changes will be needed, beyond the general possibility that changing conditions may at some time require reappraisal and changes to legislation.

13.45. In the event that there were, at some point in the future, a significant divergence in tax rates, it would be necessary to consider the possibility of introducing, or reintroducing rules to accommodate it. One possibility would be to include a regulation-making power in the primary legislation to enable any new rules to be put in place relatively easily, were that to become necessary. In the meantime, the Government welcomes suggestions as to what form such replacement rules might take.

Option 2

13.46. Under this option, corporate streaming rules would be retained so that no new legislation would be required in the event of any future divergence in tax rates. The rules

would be framed to counter attempts by investing companies which have no liability to corporation tax to obtain a repayment of the tax credit deemed to attach to the unfranked element of a streamed distribution from an AIF.

13.47. The replacement rules would have the effect of applying a tax charge for a corporate investor on the unfranked element of a streamed distribution at a rate equal to the difference between the main corporation tax rate and the rate applicable to AIFs in the relevant period. The unfranked distribution would be received by the investing company without any tax credit attached. This would achieve a broadly similar effect to the existing treatment of an unfranked streamed distribution, but without any tax credit, on which a repayment could be claimed. An alternative might be to retain the current arrangements, but simply to remove any right to repayment of the credit.

Industry-specific impacts

13.48. Unique commercial characteristics or particular tax regimes may apply to certain industry sectors. The Government welcomes comments on any potential sector-specific impacts of either of the options set out above.

Questions

Q13.10 Which of the options for the corporate streaming rules would you prefer, and why?

Q13.11 Once the main corporation tax rate and the rate applicable to AIFs are aligned, would repeal of the corporate streaming rules have any significant commercial or tax impacts, including impacts on particular sectors,? Can you quantify any such impacts?

Q13.12 If you anticipate significant difficulties arising from repeal of the corporate streaming rules, how might they be addressed?

14. Anti-avoidance measures

Introduction

14.1. This review includes as an objective a regime which is simpler and more robust against avoidance and abuse, and therefore fairer to taxpayers generally. Clearly structured legislation, which makes its intention plain, as discussed in earlier chapters, will provide a firm foundation for such a robust regime. This chapter explores what particular measures are necessary to ensure the aim is met.

14.2. The Finance Bill 2013 legislation setting out a General Anti-Abuse Rule (GAAR)¹⁶ will have effect in relation to arrangements which are entered into once the bill is passed into law. Guidance on the GAAR makes clear that it is designed to target and counteract tax arrangements which it defines as “abusive”. In addition, for the GAAR to apply, HMRC must show that the arrangements in question “cannot reasonably be regarded as a reasonable course of action” on the part of the taxpayer.

14.3. The test of “abuse”, for the purposes of the GAAR, is a high threshold, and while the GAAR may apply to certain arrangements involving the loan relationships and derivative contracts regime, it does not seek to encompass the full range of tax avoidance activity. HMRC would not normally expect to invoke the GAAR where other legislation provides an effective challenge to attempted avoidance. The need for specific legislation to protect against manipulation of the regime and inappropriate relief in respect of corporate debt and derivatives therefore remains.

14.4. It should be noted that the proposals in this chapter are based on the Government’s current view of potential avoidance activity. In the event that there were reason to believe that proposed or existing anti-avoidance rules might not have the effect which HMRC would expect in relation to particular forms of avoidance, the proposals in this chapter may need to be modified or extended.

¹⁶ Guidance on the GAAR, published in April 2013, can be found at: www.hmrc.gov.uk/avoidance/gaar.htm

14.5. Broadly speaking tax avoidance involving loan relationships or derivative contracts might be divided into four classes:

- **Detailed rules within the regime itself, including those which modify the operation of the core provisions are sidestepped or exploited with the intention of avoiding tax.**
- **Arrangements are made to ensure that amounts recognised in accounts in respect of an instrument or transaction do not accurately represent the amounts which the tax regime is aimed at.** This is usually through the exploitation of accounting rules which change the accounting presentation of a loan relationship or derivative where some other instrument or transaction outside the scope of the regime is involved. Thus, the core provisions would not bring an appropriate amount into account for tax in respect of the loan or derivative.
- **The instrument or transaction has an “unallowable purpose”.** The current “unallowable purpose” rules are contained in sections 441 and 690 CTA 2009. They can apply in situations where a company is party to a loan relationship or derivative contract, or enters into a related transaction, which has a purpose which is defined as “unallowable”. This can mean any non-business, not just a tax avoidance, purpose. It can cover avoidance arrangements which extend beyond the loan relationship and derivative contract regime itself, for example, where a company borrows to fund an avoidance scheme not related those rules.
- **The terms of an instrument or transaction do not conform to the arm’s length principle, or are part of wider arrangements which are not on arm’s length terms.** This is remedied by transfer pricing legislation. In a similar vein “base erosion” may in some cases be countered by the “debt cap” legislation in Part 7 Taxation (International and Other Provisions) Act 2010. This does not come within the scope of this consultation.

14.6. The remainder of this chapter is in two parts:

- First, (from paragraph 14.7) it considers anti-avoidance measures to counter attempts to manipulate or sidestep the provisions of the loan relationships and derivative contracts regime themselves. This section covers situations falling within the first two bullets in the previous paragraph.
- Second, (from paragraph 14.22) it looks at the “unallowable purpose” rules referred to in the third bullet in the previous paragraph.

Regime targeted anti-avoidance rule (the “regime TAAR”)

Background

14.7. The core structure proposed in Chapter 3 will reduce the scope for avoidance, since the departures from following the accounts treatment will be founded in clear principles that will make the legislation easier to apply to contrived fact patterns in a way that defeats some tax-driven arrangements. In addition, as noted above, the GAAR will deter or counter the most abusive avoidance. It is also intended that transfer pricing rules should continue to apply as they do now, subject to any wider international developments.

14.8. However, the combination of the GAAR, the unallowable purpose and transfer pricing rules will not provide the complete protection against attempts at avoidance which, experience makes clear, are to be expected in the absence of the deterrent and counteractive effects of fully functional and comprehensive anti-avoidance provisions.

14.9. The current loan relationship and derivative contract anti-avoidance provisions reflect a piecemeal approach to closing particular schemes as they have come to light by enacting closely-targeted and often detailed provisions. This process of continual repair has added to the complexity of the regime as a whole without deterring attempts to find ways around the rules or to devise new schemes. As noted earlier, this year’s Finance Bill, for example, contains measures to close down three avoidance schemes that sought to exploit the regime. The proposal below seeks to reduce to a minimum (and ideally to eliminate) the need for future reactive legislation to deal with unanticipated avoidance arrangements.

What is being proposed?

14.10. The central proposal is to replace the existing patchwork of highly specific anti-avoidance provisions spread around the current regime with a single measure (a “regime TAAR”), which would:

- cover the loan relationships and derivative contracts code as a whole;
- be triggered by a test of purpose;
- require remedies on a just and reasonable basis.

14.11. This regime TAAR would be focused, like the current piecemeal rules, on arrangements which seek to obtain a tax advantage in relation to the tax treatment of a loan relationship or derivative contract itself or the application of the regime rules themselves. Defining the principles on which the regime is based (as discussed in Chapter 3) clearly

provides a opportunity to do this. Such arrangements may involve the use of some other instrument that is outside the ambit of the loan relationships and derivative contract codes, as suggested in Chapter 4.

14.12. Such a rule could allow much of the existing piecemeal anti-avoidance legislation to be repealed, while eliminating potential gaps which might exist within and between the current very detailed and specific provisions.

14.13. The detailed wording of the regime TAAR will be developed, taking account of responses to this consultation. However, it is envisaged that the proposed rule would apply where a company is party to arrangements which have a main purpose of avoiding or exploiting the loan relationship or derivative contract rules to obtain a tax advantage for one or more parties to the arrangements. In this context, “tax advantage” would be defined by reference to an increase in deductible amounts or a decrease in taxable amounts under the regime. The rule would apply whether the arrangements sought to achieve the tax advantage by way of transactions involving only loan relationships and derivative contracts or by transactions also involving other instruments.

14.14. The proposed rule is not intended to police whether or not a loss has been incurred in pursuit of a commercial objective. Nor would it be intended to operate in respect of a company’s choice between debt and equity finance. The “unallowable purpose” rules currently in sections 441 and 690 CTA 2009, and discussed later in this chapter, will continue to be the principal protection for the Exchequer against companies leveraging themselves with debt where a main purpose of the borrowing is to obtain a tax advantage.

14.15. It is proposed in Chapter 4 of this document that, in certain circumstances, including instances of tax avoidance, where the actual accounting treatment of a loan relationship or derivative contract, or of a transaction involving such instruments, is modified by the influence of some other instrument or transaction, tax should be based on the amounts that would be brought into account in respect of the loan relationship or derivative contract, or a related transaction, in the absence of the modifying instrument. The ability to do this is essential to the effectiveness of the regime TAAR in countering avoidance. It would be necessary to harmonise the scope of the regime TAAR and the more general rule proposed in Chapter 4 to ensure that abusive arrangements are effectively countered without unintended outcomes.

14.16. Where the regime TAAR applied, it would provide for counteraction on a just and reasonable basis rather than attempting to provide detailed provisions for particular cases, which may not have been anticipated. It is proposed that the rule would require adjustment to negate the tax advantage aimed at, rather than seeking to disregard the arrangements

themselves. This approach gives a clearer indication of the intended result and of the scope of the adjustments to be made.

14.17. However, it might be helpful if the legislation were to set out indicative, but non-exhaustive, examples of counteraction linked to certain particular scenarios of attempted exploitation of the regime; alternatively this might be done in guidance. The form of the counteraction in a particular case would depend on the element or elements of the regime targeted by the arrangements in question.

14.18. Some examples of potential avoidance and counteractions under the regime TAAR are set out below. They are illustrative only, and are not intended to delineate the intended scope of the rule. Equally, the types of adjustment illustrated are not exhaustive and could have no general application under the regime – each case would depend on its facts. They are intended as examples of possible just and reasonable remedies where the purpose test of the regime TAAR is triggered.

- Amounts initially recognised in OCI or equity might be brought into account for tax, as if recognised in profit or loss, where an intention to achieve a tax advantage underlies the transaction or resulting accounting treatment. Similarly, the regime TAAR might require “tax recycling” of amounts taken to OCI and not subsequently reclassified to profit or loss in a company’s accounts.
- Adjustments might be made to counter derecognition, non-recognition or partial recognition of loan relationships or derivative contracts, or matters relating to them, with the objective of achieving a tax advantage. This could involve “looking behind the accounts”, as envisaged in Chapter 4, to establish what would have been recognised but for the instrument or transactions that led to derecognition of an instrument or income arising from it. A similar approach could be applied to bring into account for tax the full amounts that relate to a loan relationship or derivative contract, where those amounts are combined with amounts relating to instruments or transactions outside the ambit of the regime.
- Where a company becomes party to a loan relationship under another contract, for instance as a consequence of settling a derivative, adjustments might be made to ensure initial recognition at such a value that cumulatively, no amounts drop out of account for tax. Similarly, if an instrument is sold for non-monetary consideration, or is otherwise disposed of, such that full value for the asset is not fully recognised in the accounts, adjustments might be made to bring the fair value into account.

14.19. The examples above are of cases where the amounts recognised in profit and loss in the accounts are not the appropriate amounts from a tax perspective, and where a tax advantage is sought. Other forms of avoidance may involve manipulation of specific rules in the loan relationships provisions which require departure from the accounting treatment. In practice avoidance arrangements might involve both approaches, and the just and reasonable counteraction would reflect this.

14.20. Typically, the specific type of computational rules that might be exploited are those concerned with situations where there is some sort of connection between the parties. The avoidance might involve contriving to fall within, or outside those rules, arrangements that involve a change of control status, or exploitation of rules requiring a particular basis of accounting to be applied. Examples might include structured arrangements to buy back debt at a discount without triggering a tax charge, exploitation of connected party debt release rules or using group continuity provisions to access losses that would not otherwise be available. It is proposed in Chapter 7 (see paragraph 7.17) that the late interest rules in Chapter 8 of Part 5 CTA 2009 could be amended or repealed, with the regime anti-avoidance rule providing protection against deliberate manipulation of the timing of interest payable to obtain a tax advantage.

14.21. It may be that, alongside the regime TAAR, some specific additional rules may still be needed to protect the Exchequer; for instance in relation to derivative contracts with non-residents, certain deductions of interest-like amounts might be disallowed, as at present, as a surrogate for withholding tax. In addition, the rules on imported losses and corporate migrations are likely still to be needed. As the revised framework of the regime is developed, a need may emerge for other specific rules to be included in provisions dealing with particular scenarios.

Questions

Q14.1 *Do you see any difficulties in adopting a “regime TAAR” along the lines set out above? If so, how could they be addressed?*

Q14.2 *Are there any particular anti-avoidance provisions (other than transfer pricing and unallowable purposes rules, which will be retained) which need to be kept separate from the regime TAAR, and if so, why?*

Q14.3 *Would it be helpful for legislation, or guidance, to include indicative examples of potential counteractions under the regime TAAR?*

“Unallowable purpose” rules

Background

14.22. The “unallowable purpose” rules are currently found in sections 441 to 442 and 690 to 692 CTA 2009 respectively, having been in place since the inception of the loan relationships and derivative contracts codes. HMRC’s guidance on their operation can be found in the Corporate Finance Manual at paragraphs 38100 onwards and 56010 onwards.

14.23. The main features of the rules can be summarised as follows.

- Where a company is party to a loan relationship or derivative contract, or enters into a related transaction, and it has a main purpose which is “unallowable”, the debits that are brought to account for tax purposes cannot include those which are attributable to the unallowable purpose.
- An unallowable purpose is defined as a non-commercial purpose of the company; a main purpose of obtaining a tax advantage for themselves or another person is not a commercial purpose.
- The debits that would otherwise have been brought into account are disallowed on a just and reasonable basis.
- The purpose of being party to a loan relationship or derivative contract or entering into a related transaction is to be established by considering all relevant evidence and drawing reasonable inferences.
- The derivative contracts rule differs slightly from the for loan relationships rule, in that relief for debits with an unallowable purpose is still allowed to the extent that the same instrument has previously produced credits that were brought to account.

14.24. The rules can apply in the context of both domestic and cross-border financing structures. They can also apply where the tax advantage sought is external to the loan relationship regime itself; for example, it may derive from a tax avoidance arrangement financed with borrowed funds. This in turn means that the loan relationship will have an unallowable purpose even though the tax advantage may relate to an instrument outwith the loan relationships or derivative contract codes. In some circumstances, the unallowable purpose rule may be capable of operating to negate a tax advantage to which the proposed regime TAAR would also apply. It is also worth noting that the new controlled foreign company (CFC) rules in Part 9A TIOPA 2010 put beyond doubt that, in establishing the UK measure of tax profits of a CFC, the unallowable purpose rule can apply in computing those

profits. The proposed anti-avoidance rule, discussed in the first part of this chapter would be taken into account in the same way when applying the CFC rules.

Policy intention

14.25. The loan relationships and derivative contracts regimes provide tax relief for losses, expenses and interest incurred on loans and derivatives. However the regime should only give relief for costs incurred in pursuit of genuine commercial objectives: it should not provide relief for amounts attributable to unallowable purposes. “Unallowable purpose” is a broadly defined term that encompasses non-commercial activities of the company, and that includes a main purpose of obtaining a tax advantage for itself or any other person.

14.26. The unallowable purpose rule identifies loan relationships or derivative contracts that have an unallowable purpose and disallows costs which are attributable to that purpose. It should apply in situations where companies seek tax relief for accrued financing costs where there is no intention or ability for the company to bear the costs of finance or to repay the debt. It should also apply to operate in situations where the assets are acquired to justify, and with a main object of securing, a higher interest deduction.

14.27. The *Hansard* report on the Parliamentary debate on the 1996 Finance Bill explains the kind of circumstances in which the rule is expected to apply. The Economic Secretary to the Treasury stated ‘*Where paragraph 13 will come into play is where tax avoidance is the object, or one of the main objects, of the exercise.*’ (HMRC’s Corporate Finance Manual provides a full transcript at paragraph 38170). This intention has remained unchanged and has been applied consistently by HMRC and the courts when seeking to invoke the rules.

14.28. The rules have proven to be effective against many – but not all – of the schemes and arrangements that have sought to use loan relationships and derivative contracts to facilitate avoidance. Accordingly, the codes now contain additional anti-avoidance rules that seek to identify specific avoidance transactions and remove the resulting tax advantage. Many of these follow the approach of the unallowable purpose rules in seeking to identify the tainted transactions by reference to the purpose of the transaction or arrangement.

Current issues

14.29. The application of the unallowable purposes rules has in a number of areas led to extended debate, which is costly for both taxpayers and HMRC. It is important to be clear that HMRC continues to dispute interpretations being put forward in a number of cases, but clearly there are areas where the legislation is seen by some as capable of more than one interpretation, and that is unhelpful to business and a potential Exchequer risk.

14.30. Areas of dispute and uncertainty include the following:

- Where a tainted debit is brought into account as part of a larger composite amount, companies have sought to argue that the tainted debit cannot be identified and accordingly cannot be excluded for tax purposes.
- Where an existing loan relationship or derivative contract is initially entered into for commercial purposes, but is used in a later period for an avoidance purpose, it has been argued that no unallowable purpose can be established because the original untainted purpose continues or predominates over any new unallowable purpose, even where increased deductions are claimed.
- Where avoidance arrangements are funded out of a fungible pool of instruments (particularly in the financial sector), it has been suggested that no tainted purpose can be attributed to any particular loan relationship, and accordingly the rule cannot be applied. Similarly, where deposit taking institutions use pools of deposits taken in the ordinary course of their business for an unallowable purpose it is claimed that specific loan relationships used in an avoidance scheme cannot be identified and therefore cannot be associated with an unallowable purpose. Alternatively, it is argued the arrangements are to be regarded as funded specifically from accounts carrying low rates of interest, mitigating the potential for restriction of allowable debits under the unallowable purpose rules.
- The derivative contracts unallowable purpose rule permits relief of tainted debits against credits arising on the same instrument. In the past derivatives forming part of a hedging relationship have been used in avoidance arrangements, such that credits from the “in the money” leg of the hedge are sheltered from tax through the creation of artificial debits.
- It has been argued in some cases that, whilst an avoidance scheme might reduce the tax liability of a UK group as a whole, it is not possible to identify a specific UK company that has obtained a tax advantage. For example if income is moved from company A to company B and company B has losses it has been suggested that there is no tax advantage. This is because company A no longer has the right to the income and so could not be subject to tax on that amount and company B does not have a tax advantage because it paid no tax before it began receiving the income continues to have no liability afterwards.
- Where an avoidance scheme seeks to obtain a tax advantage in certain contingent circumstances (e.g. in the event of exchange rates moving in a particular direction)

groups have sought to argue that this is not an unallowable purpose as it cannot be said, in view of the uncertainty, that they have a purpose to “secure” the tax advantage.

14.31. A further area where HMRC and some taxpayers continue to hold differing views is “thinning out”. Particular difficulties arise where multinational groups undertake an internal reorganisation, which results in a substantial increase in the level of debt in the UK. HMRC currently considers the main purpose test in section 441¹⁷ to be an appropriate approach for distinguishing between situations where restructuring is driven by commercial factors and where tax avoidance is a main object of the arrangements. HMRC is monitoring this area and will continue to assess whether the UK Exchequer is adequately protected against the risk of avoidance.

What is being proposed?

14.32. The proposals below are intended to address the perceived uncertainties over the application of the rules set out above.

- The revised framework will put beyond doubt that composite amounts brought into account can be unpicked to the constituent parts to identify amounts attributable to an unallowable purpose. This approach is discussed in Chapter 4, and in this chapter in relation to the regime TAAR.
- It is proposed to revise the definition of a related transaction to include anything that amounts to, or has the same substantive effect as, a related transaction. This will assist with blocking schemes and arrangements that seek to exploit perceived weaknesses between legalistic and accounting terms.
- It is proposed to put beyond doubt that the use of fungible pools of funding in avoidance transactions will not prevent the rule from applying; where a pool of funding is used for an unallowable purpose it will be deemed that the fungible funding used was entered into for an unallowable purpose and the rule will apply to disallow the appropriate amounts for tax purposes. To counteract the tax advantage a portion of the company’s cost of funding will be disallowed on a just and reasonable basis. Where a specific pool can be identified from which the funding was drawn, it would be appropriate to disallow a percentage of the cost of funding that specific pool: otherwise it may be appropriate to disallow a percentage of the overall funding cost for the

¹⁷ Other rules, such as tax arbitrage (Part 6 TIOPA 2010) and the worldwide debt cap (Part 7 TIOPA 2010), may also be relevant.

business. This decision would continue to be made for each accounting period on a just and reasonable basis, taking all of the facts into consideration.

- In the context of derivative contracts we propose to remove the ability to set debits against previous credits arising on the same instrument. If the derivative is held for an unallowable purpose, relief for any debits arising from it will be restricted on the normal just and reasonable basis, with any credits being taxed as normal. This will align the rule with the equivalent provision for loan relationships.
- It is proposed to put beyond doubt that the determination of a tax advantage does allow for consideration of the group's position as a whole; all relevant facts and circumstances will be taken into account.
- It is proposed to put beyond doubt that the unallowable purpose rules apply where a company is party to a loan or derivative with a main purpose of obtaining the chance (not necessarily a certainty) of securing a tax advantage.

Questions

Q14.4 Will the proposals set out in this chapter be effective in tackling tax avoidance arrangements using loan relationships and derivative contracts for an unallowable purpose?

Q14.5 Will the proposals for the “unallowable purpose” rules impact on commercial transactions where there is no intention to avoid tax?

Q14.6 Do you anticipate difficulties generally with the proposals set out above? If so, how might they be addressed?

15. Tax Impact Assessment

15.1. The proposals and preferred options outlined in this document are broadly aimed at updating, rationalising and simplifying the existing regime rather than at radical reform or change. Accordingly, no impact on the UK economy generally is anticipated. Similarly the Government is not aware of any potential direct impacts on individuals or of any equality impacts.

15.2. The Exchequer impact will depend on the proposals adopted and their final design, and these will themselves be influenced by consultation responses. The changes will in part support the Government's aim of reducing tax avoidance and can therefore be expected to raise or protect revenue in cases of artificial abuse. Any final Exchequer impact will be assured by the Office for Budget Responsibility. The responses to the consultation will contribute to the Tax Information and Impact Note which will be published alongside draft legislation.

15.3. One of the aims of the changes is to reduce administration burdens and compliance costs arising from the operation of the loan relationships rules as they stand. We need to estimate, ultimately in monetary terms, any such reduction. The questions below are designed to assist in that process, but as elsewhere, more general comment is welcome.

Questions

Q15.1 Subject to detailed policy design and drafting of legislation, would you expect the proposals or options in this document to impact significantly on the amount or timing of tax payable by businesses of which you have experience? If so, how and why?

Q15.2 What is your evaluation of the cost, to businesses of which you have experience, of complying with the loan relationships and derivative contracts tax rules as they stand? How do you arrive at your conclusion?

Q15.3 What impact do you think the measures proposed in this document would have on your evaluation, and why?

Q15.4 Are there other measures or approaches which could, if adopted, significantly reduce administrative burdens or compliance costs?

Where it is appropriate, it would be helpful for responses to this chapter to address separately impacts relating to loan relationships and derivative contracts held for trading and non-trading purposes.

It may be helpful to pursue these questions further with respondents. If you would be willing to participate in further discussions, it would be helpful if you would indicate that in your response.

16. Summary of Consultation Questions

This document contains a number of specific questions, and these are summarised below. However, as noted earlier, respondents should not feel necessarily constrained to restrict their comments to those specific points; more general thoughts on the issues raised are also welcome.

Chapter 2 Introduction

Q2.1 Do you think the timetable proposed in paragraphs 2.14 to 2.18 is practicable? If not, how could it be adjusted?

Chapter 3 The framework

Q3.1 Do you think the approach outlined in Chapter 3 would provide a secure basis for determining the existence of matters within the scope of the regime and the taxable amounts?

Q3.2 If not, why not and how could the policy intentions be realised?

Q3.3 Would a requirement to the effect that amounts brought into account should represent the full amount of the profits, losses and gains from a loan relationship be adequate, or would any further qualification of, or addition to, those words be useful (see paragraph 3.23)?

Q3.4 Would it be helpful to make the categories set out in Figure 3 explicit in legislation?

Q3.5 Do the categories set out in Figure 3 comprehensively capture the scope of potential departures from the default process?

Chapter 4 Looking behind the accounts

Q4.1 Do you agree with the rule proposed in paragraph 4.21 concerning the identification and measurement of amounts to be taken into account?

Q4.2 In what circumstances should such a rule apply?

Q4.3 Do you anticipate any particular difficulties with the rule proposed in paragraph 4.21? If so, how might they be addressed?

Q4.3 Are there specific circumstances (other than where there is no material impact on tax outcomes) in which such a rule should not apply? If so, what alternative approach could be taken in such cases?

Chapter 5 Accounting issues

Q5.1 Would you support the proposed “follow the profit and loss” approach set out in paragraphs 5.12 to 5.15?

Q5.2 Do you anticipate difficulties with a “follow the profit and loss” approach? If so, how might they be addressed?

Q5.3 Would you support the proposal to simplify the changes of accounting policy rules so that they are based on tax adjusted carrying value in all cases (see paragraphs 5.17 to 5.21)?

Q5.4 Do you anticipate difficulties with the proposed simplification of the change of accounting policy rules? If so, how might they be addressed?

Q5.5 Would you support changes to align and clarify the terminology used in the legislation dealing with the treatment of capitalised amounts and the recycling of designated cash flow hedges, and why?

Chapter 6 A unified regime for loan relationships and derivative contracts?

Q6.1 What benefits and difficulties would you anticipate from combining the loan relationships and derivative contracts codes into a single body of legislation with shared machinery provisions?

Q6.2 How might any difficulties be addressed?

Q6.3 Overall, would you support such a change?

Chapter 7 Connected party debt

Q7.1 Which of the options outlined above do you prefer, and why?

Q7.2 Do you anticipate difficulties with Option 2 set out at paragraph 7.12 to 7.14 and, if so, how might they be addressed?

Q7.3 Which of the approaches set out in paragraph 7.14 would be preferable?

Q7.4 Are there other relevant issues which are not addressed in this chapter and, if so, how would you address them?

Chapter 8 Intra-group transfers (group continuity)

Q8.1 What is your preferred approach, and why?

Q8.2 Do you see any difficulties with any of the options set out and, if so, how might they be addressed?

Q8.3 To what extent does ensuring tax neutrality on intra-group transfers of loan relationships and derivative contracts remain an important commercial consideration?

Q8.4 How would the changes proposed under each option ease or intensify the burden of complying with group continuity?

Q8.5 Are there issues with the group continuity rules not considered in this chapter and, if so, how might they be addressed?

Chapter 9 Partnerships and transparent entities

Q9.1 Which of the options outlined above would you prefer, and why?

Q9.2 Are there particular circumstances where you would see Option 3 as being either appropriate or inappropriate?

Q9.3 Are there any types of arrangement, other than foreign entities treated as transparent and trust arrangements, where you consider the partnership approach could or should be adopted?

Q9.4 Are there other relevant issues not addressed in this chapter? If so, what are they and, how might they be addressed?

Chapter 10 Exchange gains and losses and hedging

Q10.1 Do you anticipate difficulties with the proposal to tax forex movements only in respect of instruments held for trading or property business purposes? If so, what are they and how might they be addressed?

Q10.2 Do you anticipate particular difficulties with the proposal for the treatment of hedging instruments and, if so how might they be addressed?

Q10.3 In view of developments in accounting standards, do you anticipate that companies with hedging relationships will generally be able to opt to apply hedge accounting?

Q10.4 Are there other significant issues with the treatment of forex gains and losses and hedging which are not considered in this chapter? If so, what are they and how might they be addressed?

Chapter 11 Debt restructuring

Q11.1 Do you anticipate difficulties arising from the proposals in paragraph 11.17? If so, what are they and how might they be addressed?

Q11.2 To what extent, and how, could the difficulties listed at paragraph 11.16 be addressed by a recasting of the wording of the exemptions?

Q11.3 Are there other significant issues in this area not addressed in this chapter? If so, what are they and how might they be addressed?

Chapter 12 Hybrid and special treatment instruments

Q12.1 Do you agree with the approach proposed in paragraph 12.14 in respect of holders of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?

Q12.2 Do you agree with the approach proposed in paragraphs 12.16 to 12.22 in respect of issuers of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?

Q12.3 Do you anticipate practical or computational difficulties or tax avoidance risks arising from different approaches to the taxation of holders and issuers, as proposed? If so, how could they be addressed?

Q12.4 Are you aware that the property derivative rules are in fact used in any non-avoidance context?

Q12.5 Do you support the proposal to repeal the property derivative rules? If not, what would be an alternative approach?

Index-linked gilts

Q12.6 Could a redrafting of the rule currently in section 400 CTA 2009 along purposive or principles-based lines effectively target the relief in respect of increases in value attributable to inflation and prevent abuse?

Q12.7 If not, how could the relief be targeted to provide relief in respect of index-linked gilts held for genuine commercial purposes while eliminating opportunities for abuse?

Chapter 13 Bond funds and “corporate streaming”

Bond funds - AIFs and UUTs

Q13.1 Overall, would you support the proposed reform of the bond fund rules in Chapter 3 of Part 6 CTA 2009, and why?

Q13.2 How significant are the risks mentioned in paragraph 13.24 and how could they be mitigated?

Q13.3 Would the proposed reform of the bond fund rules involve other risks to the Exchequer or to taxpayers? If so, how could they be mitigated?

Q13.4 Do you think the anti-avoidance rules proposed in paragraphs 13.25 to 13.27 are necessary and appropriate? Is there a better approach to preventing exploitation of bond funds for tax purposes?

Bond funds - Offshore funds

Q13.5 Overall, would you support replacement of the current rules in Part 6 of CTA 2009 as they apply to holdings in offshore funds with rules similar to those in S378A ITTOIA?

Q13.6 Would the introduction of such rules lead to serious practical difficulties for taxpayers or HMRC? If so, how might they be mitigated?

Q13.7 What would you expect to be the extent of any deferral or loss of tax arising from the rolling up of interest in OFs?

Bond funds – Life insurance companies

Q13.8 What would be the commercial or tax effects on life companies of the proposals above in respect of bond funds?

Q13.9 If it is anticipated that the proposals would cause particular difficulties for life companies, what are they and how might they be mitigated?

Corporate streaming

Q13.10 Which of the options for the corporate streaming rules would you prefer, and why?

Q13.11 Once the main corporation tax rate and the rate applicable to AIFs are aligned, would repeal of the corporate streaming rules have any significant commercial or tax impacts, including impacts on particular sectors? Can you quantify any such impacts?

Q13.12 If you anticipate significant difficulties arising from repeal of the corporate streaming rules, how might they be addressed?

Chapter 14 Anti-avoidance measures

Q14.1 Do you see any difficulties in adopting a “regime TAAR” along the lines set out in this chapter? If so, how could they be addressed?

Q14.2 Are there any particular anti-avoidance provisions (other than transfer pricing and unallowable purposes rules, which will be retained) which need to be kept separate from the regime TAAR, and if so, why?

Q14.3 Would it be helpful for legislation, or guidance, to include indicative examples of potential counteractions under the regime TAAR?

Q14.4 Will the proposals set out in this chapter be effective in tackling tax avoidance arrangements using loan relationships and derivative contracts for an unallowable purpose?

Q14.5 Will the proposals for the “unallowable purpose” rules impact on commercial transactions where there is no intention to avoid tax?

Q14.6 Do you anticipate difficulties generally with the proposals set out in this chapter? If so, how might they be addressed?

Chapter 15 Tax impact assessment

Q15.1 Subject to detailed policy design and drafting of legislation, would you expect the proposals or options in this document to impact significantly on the amount or timing of tax payable by businesses of which you have experience? If so, how and why?

Q15.2 What is your evaluation of the cost, to businesses of which you have experience, of complying with the loan relationships and derivative contracts tax rules as they stand? How do you arrive at your conclusion?

Q15.3 What impact do you think the measures proposed in this document would have on your evaluation, and why?

Q15.4 Are there other measures or approaches which could, if adopted, significantly reduce administrative burdens or compliance costs?

17. The Consultation Process

17.1. This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

- Stage 1 Setting out objectives and identifying options.
- Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
- Stage 3 Drafting legislation to effect the proposed change.
- Stage 4 Implementing and monitoring the change.
- Stage 5 Reviewing and evaluating the change.

17.2. This consultation is taking place at stages 1 and 2. Some chapters of this document set out a proposed way forward, while others set out options; where options are proposed, the Government's current preference is made clear. Although the primary purpose of the consultation is broadly to seek views on policy design within the framework of the proposals and options set out, the Government will nonetheless be interested to hear alternative suggestions as to how the policy objectives identified in this document might be achieved.

Further consultation

Open meeting

17.3. To complement this document, the Government will hold an open meeting. This will be open to all and will take place in London. It will take place on 27 June 2013 and will last around 2 hours. The purpose will be to introduce the consultation, explain the broad thinking behind it and give an opportunity for participants to make high level comment. Clearly it will not be possible to engage in detail on all the issues raised in this document; the meeting is intended to be helpful in framing responses to the consultation

17.4. **Space will be limited and there is controlled access to the building. Therefore, for reasons of practicality and security, if you wish to attend this meeting, you must notify Karin McHardy by email at:**

karin.mchardy@hmrc.gsi.gov.uk.

17.5. **This will also ensure that you can be notified of the arrangements and any changes. You are asked to give notification as early as possible; if it is necessary to**

limit numbers attending, this will be done on a first come, first served basis, and multiple applications from individual organisations may have to be limited.

Working group

17.6. HMRC will be establishing a working group to act as a forum for detailed discussion of issues arising from the consultation. This is expected to meet regularly over the course of the project. To ensure that this group is effective and broadly representative, membership will be limited and by invitation. If you would like to be considered for inclusion in this group, you should contact Karin McHardy by email, briefly explaining your interest.

Finance Bill 2015 measures

17.7. Further consultation on detailed changes and draft legislation is also envisaged. For measures to be included in Finance Bill 2015, further formal consultation is likely to take place in 2014, although informal engagements and the work of the working group are expected to be continuous processes.

How to respond to this consultation document

17.8. A summary of the questions in this consultation is included at chapter 16.

17.9. Responses should be sent by 29 August 2013, by e-mail to andy.stewardson@hmrc.gsi.gov.uk or by post to:

Andy Stewardson
HM Revenue & Customs
Room 3C/06
100 Parliament Street
London
SW1A 2BQ
Telephone enquiries 0207 147 2600.

17.10. This document can be accessed from the HMRC Internet site at <http://www.hmrc.gov.uk/consultations/index.htm>. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

17.11. When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

17.12. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

17.13. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

17.14. HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

17.15. This consultation is being run in accordance with the Government's Consultation Principles.

17.16. The Consultation Principles are available on the Cabinet Office website:
<http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>

17.17. If you have any comments or complaints about the consultation process please contact:

Amy Burgess, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

17.18 Please do not send responses to the consultation to this address.