

## **Technical Note on measure announced at Autumn Statement: Avoidance using Total Return Swaps.**

### **Revised Note on clauses.**

1. This measure was published at Autumn Statement, with immediate effect. Concerns were raised about the potentially wide effect of the measure on normal commercial transactions, so revised clauses were published on 23 January. The revised clauses make some changes to the clause which are explained below. The effect of the changes is largely to clarify the effect of the clauses rather than to make substantive changes.
2. This note:
  - sets out the original purpose of the legislation,
  - summarises the differences between the original and new drafts.
  - gives more detail of how it will be applied in practice
  - gives some examples of arrangements to which it will and will not apply
  - this amended version was published in April 2014 to expand on Examples 2 and 5.

### **What is the purpose of the legislation?**

3. The clause is intended to close down an avoidance scheme. In that scheme, a company enters into a derivative contract known as a total return swap, with a parent company or another group company, generally located in a tax haven. Under the contract, all of the profits of the company are paid away in return for much smaller payments back. A deduction is claimed for the payment under the contract, leaving little or no profit chargeable to tax.
4. The Government considers that it is not acceptable for groups to try to obtain tax relief for payments that are in substance distributions of profit, and the measure aims to prevent this by providing that no deduction is given for arrangements where there is a payment in substance of the profits of a company to another company in the same group.

### **Changes to legislation**

5. The revised legislation can be found at:  
<https://www.gov.uk/government/publications/finance-bill-2014-measures-with-immediate-effect>. . The main changes are as follows:
6. The title has been changed from ‘Derivative contracts between group companies’ to ‘Disguised distribution arrangements’.

7. Subsection (1)(d) has been changed to refer to a payment of all or a significant part of the profits, instead of to all or part of the profits.
8. Subsection (1)(e) is a new subsection which provides that arrangements are not caught by the legislation if they are arrangements of a kind which companies carrying on the same kind of business as the company would enter into in the ordinary course of that business.
9. Sub-section (2) has been changed and a new subsection (3) added so that credits caught by the clause are not brought into account only to the extent that debits have been disallowed in respect of the same arrangements.
10. The commencement provisions from subsections (2) to (6) have been modified and extended to clarify them and to allow for the changes mentioned at paragraph 9.

### **Application of the measure**

#### **What do we mean by profits?**

11. The measure is aimed at contracts which move profits. This may be the profits as shown in the accounts of a UK company, or another payment designed to give the same effect.
12. Profits in this context means broadly a sum which is receipts less expenses, as generally used in the Taxes Acts. Payments which are in substance the same are also caught, to prevent easy avoidance of the measure.
13. It should be borne in mind that profits does not mean the same as a receipt, or a series of receipts. So for example under a commercial contract where a fixed interest rate is swapped for a floating interest rate, the sums exchanged will not be profits of the company, but one item (a receipt or expense) which features in arriving at the profits of the company. These sums would therefore not be profits of a company, and would not ordinarily be the target of this legislation.

#### *Payments akin to distributions*

14. The title has been changed from 'derivative contracts between group companies' to 'disguised distribution arrangements'. This has no effect on the substance of the legislation, but is intended to give a pointer to the target of the legislation; the payments being targeted by the measure are those which are in effect distributions of profits, although not taking the legal form of distributions. The payment under the contract is not a legitimate deduction in arriving at profits or tax purposes, but a sum of profits which has been made, and is now being paid away to another group company.

#### **Whole or a substantial part of the profits of a business (subsection 1(d)).**

15. Subsection 1(d) has been changed so that instead of referring to the profits or part of the profits, it refers to the profits or a significant part of the profits.
16. This is intended to make it clear that the main target is arrangements where the profits of a company are transferred after having been earned rather than individual transactions which may feature in arriving at the profits.

### **Ordinary course of business**

17. The revised clauses include an additional subsection (1)(e). This subsection provides that an arrangement is not caught by the clause if it is a kind which companies carrying on the same kind of business as the company which is party to the arrangements would enter into in the ordinary course of that business.
18. This means that, for example, if a bank issued a derivative for hedging purposes, and it was a type of business which that bank (or other banks) routinely entered into in the normal course of business, then it would not fall within the clause. References to hedging in this note may include cases where the purpose of entering into the derivative is to transfer all, or part of, the risk and/or reward arising in respect of one or more assets (and similarly for liabilities).
19. This is in addition to the requirement that the contract should result in a profit transfer, and so in this case it is likely that the arrangements would not meet the transfer of profits requirement in (1)(d), as well as being in the normal course of business, as mentioned in 1(e).
20. Some questions which occur in connection with this condition are as follows:
  21. *If a company has only a limited number of activities, or a single one, then what is the normal course of its business?*
  22. It is appropriate here to look at all of the circumstances, i.e what group the company forms part of, and why the payment is being made.
  23. Bear in mind that the legislation refers to the result of the arrangements, to which other parties will undoubtedly be parties, so it is appropriate to look at what is going on with all of the companies involved.
  24. *What happens where an activity is a commercial activity, but one which by its nature may not be entered into very often. For example, a manufacturing company might take out an interest rate swap to hedge its borrowings, but only do this on rare occasions.*
  25. As mentioned above, it is most unlikely that a swap of this type would amount to a transfer of profits. However the ordinary course of business test provides an additional safeguard. While an individual company might only rarely enter swaps of this kind, the test allows companies to look at what other

companies of the same kind might do, and this would allow them to reach the conclusion that manufacturing companies do often enter interest rate swaps in the course of their business, so viewing companies of that type as a whole it is clear that the requirement is met.

26. This can be contrasted with avoidance cases, as it is clear that manufacturing companies do not in the ordinary course of business give away their entire profits in return for negligible benefits.
27. *What if an activity is entirely novel, so that it has not featured in the activities of any company previously?*
28. A novel activity could of course be in the ordinary course of business, if the company is generally involved in developing novel products or activities. It is also open to the company to seek reassurance from HMRC that the legislation does not apply. Bear in mind that the arrangement will also have to meet the transfer of profits requirement mentioned above so it is likely that in most cases it will be clear that a product or activity does not transfer the profits of a business.

#### *Securitisations*

29. It is likely that in the vast majority of cases, either subsection 1(d) or 1(e) will exclude securitisation arrangements from being caught by the legislation. If derivatives are used within a group of companies, then it is likely that in most cases the sums transferred will not be to transfer profits, but rather to exchange different flows of payments, for example, the return on one tranche of loans for the return on other assets.
30. A derivative could possibly be used to transfer profits at the end of a securitisation process, for example to transfer residual profits from a special purpose vehicle (SPV). However, viewed together, it is likely that overall the return of profit would effectively be a component in the purchase price of loans transferred, in other words, it will be part of a market value transaction, rather than a payment equating to a distribution.
31. And finally, the ordinary course of activity exclusion should apply to cover genuine situations.

#### **Exclusion for hedging of derivatives (former subsection (4)).**

32. The previous clause contained a specific exemption where a company used derivatives within the group to hedge derivatives written with third parties.
33. This was not intended to be exhaustive, but was intended as a convenient exclusion so that companies using this type of derivative could be assured quickly that those derivatives were not caught by the measure.

34. We were informed that this exclusion could in fact be misleading, and give the impression that derivatives which are hedging other assets, such as equities, were intended to be caught by the measure.
35. In the revised clauses, the specific exemption has now been removed, as this type of hedging arrangement is now fully included within the more general exclusion in subsection 1(e).
36. Where a company uses intra-group derivatives to hedge business with third parties, in the normal course of business, then this will be included within 1(e), whether the contracts with third parties hedge derivatives or other assets.

### **Debits or credits not brought into charge (subsections 2 and 3).**

37. The section which provided that debits or credits were not to be brought into charge where the legislation applies has been changed so that credits are only not brought into charge to the extent that relief was previously denied for debits under the same arrangements. This is not seen as having any significant effect as the avoidance arrangements seen by HMRC generally involved much larger debits than credits.
38. The commencement provision in section 3 of the clause has been changed to refer to “accounting period” rather than “period” purely for clarification. This does not alter the effect of the legislation.
39. Commencement date for the clauses is still 5 December, with the exception of the change to subsection (2) mentioned above which is now 23 January.
40. The commencement provisions have also been redrafted for clarity so that a new accounting period is deemed to arise on 5 December 2013 for the purposes of this clause.

## **EXAMPLES**

### **Example 1**

A company carries on a financial business in the UK employing a number of skilled traders. The company enters a contract where 100% of the profits, as shown in the accounts, are paid to a fellow group company located in a tax haven. The other group company agrees to pay a sum equal to 20% of the profits back to that other company, and to meet losses made by that company, should any arise. This is caught by the legislation, as in substance the profits of the business are paid to the fellow group company.

### **Example 2**

A client of a banking group wishes to get exposure to a certain class of underlying asset (e.g. equities). It enters into a contract with a bank. The bank does not itself hold the underlying assets, which are held by another group company.

The contract with the customer has to be entered into by the bank, and not by the other group company, for commercial and regulatory reasons. It is not possible to transfer the assets from the other group company to the bank, again for regulatory and commercial reasons. So the bank enters the contract with the customer, then uses a TRS to pass on the return on the assets from the other group company to the bank.

This will not be caught by the new clauses (either in relation to the bank or in relation to the other group company) as:

- the contract is passing on return from assets, not the profits of a company
- this is in the ordinary course of the bank's business

### **Example 3**

A group is involved in a securitisation of mortgage portfolios. A group company has issued mortgages to thousands of individual customers. These mortgages are used in a securitisation to back bond issues by a special purpose vehicle. As part of the securitisation, total return swaps are used to transfer the return on the mortgages between group companies.

The arrangements here are not caught by the legislation since:

- while returns on different types of lending are exchanged, these contracts do not at any point move the profits of a company
- this is in the ordinary course of business.

### **Example 4**

A bank has a UK subsidiary which trades in derivatives. The derivatives are hedged within the group by entering into a total return swap with a fellow subsidiary. This is not caught by the legislation as the total return swap moves the return on derivative contracts, rather than profits of the company, and is entered into in the normal course of business.

### **Example 5**

A UK subsidiary of a banking group makes a loan to a client in the UK. Whether as part of wider arrangements to centralise the management of credit exposures within a particular entity or location, or as an isolated hedging transaction, the lender enters into a credit default swap with a company (which may be overseas) in the same banking group to hedge against losses on the loan. This is not caught by the legislation as it does not involve paying away the profits of the business, just hedging defined credit exposures, and will be in the ordinary course of business.