Minutes of WG1 meeting on 28 November 2013

HMRC asked the group to forward any comments on notes of last meeting. The minutes will be published in due course.

HMRC noted that the key discussion point for this meeting would be the discussion paper circulated by HMRC, which expands on the comments and proposals in Chapter 4 of the consultation document of 6 June 2013 (the condoc) on looking behind the accounts.

There has already been some discussion about Chapter 3 and, in particular, the role of 'fairly represents' – HMRC has received clear messages from the working group and respondents to the condoc that there could be significant difficulties with the of a general override to the basic 'follow profit and loss in the accounts' approach, perhaps akin to, or derived from, the requirement currently in section 307(3) Corporation Tax Act 2009 (CTA 2009) to 'fairly represent' profits and losses etc. In response to this, HMRC is prepared to explore the possibility of a different way forward.

The condoc also sets out particular areas where specific departures from the default rule would be necessary. There is general acceptance in principle that such specific provisions are needed.

Chapter 4 – looking behind the accounts

Introduction

Chapter 4 proposes a rule which is potentially midway between general and specific. HMRC is interested to explore how such an approach, as developed from Chapter 4, might contribute to the overall structure of the regime. HMRC noted that the discussion paper is very much a development of the proposals in the condoc, from which it does depart in a number of areas.

The key difficulty with a general override cited by consultees was uncertainty, and the main source of this uncertainty would be the difficulty of identifying and defining with sufficient clarity an alternative to the accounts in determining taxable amounts. Chapter 4 proposed that where the amounts recorded in the accounts in respect of matters within the scope of the loan relationships and derivative contracts regime ('LRDC matters) were influenced / interfered with by other transactions, instruments, etc, then one would be required to identify and measure the amounts related only to the LRDC matters. If over the life of arrangements, the taxable amounts would be materially different in nature or amount due to the interference, then it would be necessary to bring them into account separately. The condoc uses the term 'economic profit' to describe what should be brought into account.

There are a number of areas of difficulty with the proposition as set out in Chapter 4 - how do you identify what 'interference' is, how do you know whether the taxable amount is materially different from the economic profit (how do you know what economic profit is), how do you establish whether a material difference will arise over the life of the arrangements and finally, if you have to invoke rule, what happens to the interfering item itself and does this need to be addressed in the LRDC regime?

The discussion paper moves on from this. One of the key areas where the paper differs from the condoc is that there is no mention of economic profit. Instead, the paper suggests that the approach should be that, where 'interference' is identified, one must look to apply the accounting treatment that would have applied had the LRDC matter been accounted for on standalone basis without the influence of the 'interfering' item. Is this a step forward and, if so, is it a big enough step that it would effectively address the uncertainty issue? The paper also no longer refers to the lifetime of the arrangements but only to the period in question.

There are still questions around whether it is possible to identify the interference sufficiently clearly and what this means as regards uncertainty. Also, in some situations, the impact of the interference is probably acceptable (e.g. hedging) but in other situations the rule should apply – is it possible to distinguish with sufficient clarity? Is a rule which requires the LRDC matter to be accounted for on a

standalone basis a sufficiently solid approach that users of the legislation would understand what needs to be done?

Initial views

The question was asked whether it would be necessary to consider each loan relationship individually or was the proposal that items would only need to be unbundled if certain conditions are met? HMRC agreed that the latter approach would be preferable.

The group noted that the discussion paper concludes that the rule is unlikely to be needed much in practice so it would be attractive if it was designed such that it only needed to be considered in those narrow sets of circumstances.

It was agreed that a rule would be needed to deal with specific situations such as derecognition and the move away from some form of 'fairly represents' and back towards accounting was very positive, though, in practice, it may be difficult to get hypothetical answers from accountants.

The most important issue is likely to be working out when the rule should apply - 'the gateway'. In this regard, it would be useful to see what type of examples HMRC has in mind. The paper suggests that hedging and repos, for example, should be dealt with separately, and there are also other items where the accounts give an appropriate answer anyway so there is a need to define more clearly what should go through the gateway.

At the moment, there are a number of rules that allow you to ignore certain influences – the derecognition rules (in avoidance situations), the disregard regulations for hedging transactions, the repo provisions, etc. There is a question as to what is currently missing that would need to be addressed under the new rules. HMRC agreed that one way forward might be to try to identify every instance where the amounts need to be unbundled and write a specific rule to deal with the situation. Conceptually this is an alternative, but does leave the rules reliant on the ability of the legislators to identify all scenarios that need to be addressed and provide for solutions that give an appropriate outcome in all cases.

The group queried whether transparent entities were within the scope of this rule. HMRC said that the issue was slightly different though it was in the same area. One difference between tax and accounting is the concept of entity – the accounts of an entity won't always represent the profits from its loan relationships as there may be amounts in other accounts which should be included for tax purposes. It was not clear whether the rule being proposed would cover these scenarios. It does need to be addressed but it could either be something similar to this or they could use the partnership rules.

Structure

The genesis of Chapters 3 and 4 of the condoc was the desire to have a regime that clearly delineates its scope and what it is trying to do. There is a need to seek to define what exactly the regime is seeking to tax in terms of LRDC matters. The preference would be to identify the core scope of the regime and develop, as far as possible, clear general rules rather than starting by considering individual instances and working out specific rules. However, if there is another way of structuring the regime then HMRC is happy to look at this.

In terms of the structural hierarchy of the regime, HMRC had envisaged having a rule of this kind at the beginning when setting out what the legislation is about and then specific rules set out in a coherent way to deal with specific instances when there is a need to modify or depart from the basic approach. With regard to the looking behind the accounts kind of rule, the choice would be between including a rule in the principles at the core of the regime or taking the view that this is just another instance where there is a requirement to modify the core approach.

Objective

The group discussed how the 'interfering' item might be dealt with and whether the LRDC regime would need to provide for specific rules. Some rules may be required to deal with any interaction with the chargeable gains rules for example.

One of the working group members queried whether the objective was just to deal with boundary cases where the other ('interfering') item is not subject to tax under an accounts based regime. HMRC confirmed that it was not just about boundary cases. Even if the 'interfering' item is another LR, you may get a different answer in some cases. The regime requires one to identify the profit / carrying value of a particular instrument, not influenced by other items, even similar instruments. It was suggested that these scenarios (e.g. where back to back loans are accounted for as a derivative) are more about allocating credits and debits. This is different to derecognition where one has to derive new accounting rather than just identifying the numbers from existing entries in the accounts.

The rule being put forward implies that one needs to separate the LRDC matter and the 'interference' and in effect account for the LRDC matter independently for tax purposes. It was suggested that this moves into a parallel universe where the regime is no longer taxing real commercial profits and losses. It might give a sensible answer or it might give a bizarre answer – the preference would be to avoid this deeming approach. The counter-argument to this is that, if the regime is intended to tax profits on LRDC matters and the accounts are demonstrably not showing these profits due to the influence of other items, then it must be right to try to extract the amounts that the regime is seeking to tax. The key point from HMRC's perspective is that the regime is trying to identify profits, etc on LRDC matters. Sometimes, this means that one needs to do 'something' other than simply take the amounts shown in the accounts, in order to achieve the aim of legislation. This 'something' may not necessarily be the approach set out in the paper but, if not, there is still a need to establish what this 'something' is in order to ensure that the right amounts are subject to tax.

One working group member suggested that the fundamental point is that corporation tax is a tax on profits, the LRDC regime is part of the corporation tax regime and 'profit' is a commercial concept and determined by reference to the accounts. The response to this is that the accounts show the profits arising to the entity overall but may not necessarily show the profits on the company's LRDC matters. Further from a tax perspective, due to the interaction with regimes which are not accounts based, e.g. chargeable gains, simply following the accounts will not always give the right taxable result, e.g. the accounts might not show anything because there is a chargeable gain offset by a gain on a derivative contract but the chargeable gains regime will still pick up the gain. Depending on the circumstances, it may be appropriate to ensure that the loss on the derivative contract is also picked up.

It was suggested that it might be helpful to work out the categories in question – there are a lot of items which are already covered under the existing legislation and there are a number of situations where the result per the accounts is acceptable anyway. One thing that isn't apparent from the discussion paper is the extent to which there are differences between what is being proposed and what we already have. If there are specific concerns, then these should be addressed but first these issues need to be identified. It was noted that it may easier to derive a general rule from the specific examples than trying to start with a general rule where the target is not clear.

Identification / allocation versus imputation

One of the difficulties is that there are a number of different issues. There is a computational, practical question which is dealt with by 'fairly represents' under the current rule. However, this is where the amounts are already in the accounts. This is different from derecognition where there are just no amounts in the accounts. It is also different from hedge accounting where the amounts are in the accounts, but it is necessary to decide how to treat those amounts for tax purposes. The differences mean that it may be difficult to derive a general rule.

A question was asked whether it is policy that the company always has to gross account for tax purposes?

Taking derecognition for example, other than in avoidance cases, the reason that amounts are not recognised in the accounts is that the company does not have the risks and rewards – why should this not be accepted for tax purposes? HMRC was not saying that individual accounting for individual instruments is always required. If a bundle of instruments is treated in the accounts in a particular way but you would get the same answer if they were accounted for separately, then there is no problem. It is not clear, however, how far you would need to go to find out if the result is the same. The group wasn't sure whether it was correct to treat each instrument as a different source or whether they should be taxed on an aggregate basis. The general feeling seemed to be that while some special rules are needed to deal with cases involving interaction with items which are not subject to tax based on profit and loss in the accounts, we shouldn't have a general rule which requires each LRDC item to be considered and taxed separately.

It was noted that if the rule operates by way of an annual test and there is some form of gateway / trigger to be considered each year, there could be significant difficulties if instruments are moving year on year. Unless the lifespan of the instrument is understood, this could have unintended results. In response, it was suggested that, if it is accepted that the target of the regime is profits / gains on a particular loan relationship, then it shouldn't matter if this appears in isolation in the accounts one year and then has to calculated independently the following year as the amount is no longer apparent from the accounts due to the influence of another transaction / instrument. However, it was acknowledged that, once one has to consider hypothetical accounting for an instrument in one period, it will have to continue for the rest of the life of the instrument. This is an inevitable consequence of having a rule which requires consideration of a counterfactual. It was also noted that one of the difficulties with imposing a counterfactual is that one might get different answers to a hypothetical question put to accountants.

It was suggested that there may be a solution in other regimes which are also accounts based, e.g. trading, intangibles, etc. HMRC agreed that this may be worth pursuing. However, another working group member noted that the loan relationships and derivative contracts regime had been subject to far more changes over its lifetime than other regimes and it was quite different.

The disadvantage of a general rule is that all taxpayers have to consider the rule in every period and determine whether the instrument needs to be considered independently. If the rule came in at the end of the process, once the other rules had done their work, it might be easier to determine whether or not there was still some interfering transaction, which requires unbundling. It was suggested that it would represent a fairly significant backward step if such a general rule formed part of the core of the regime. If there is a specifically defined set of circumstances where the rule might apply and it only switches on when triggered then it should be possible to limit its application.

The group asked again whether there were any practical examples of where the existing regime is giving the wrong answer? It was agreed that, if the capitalised interest rule didn't exist, the rules would give the wrong answer. However, it was not clear whether the rules as they stand would give any 'wrong' results. The question was asked as to what substantial practical difference will exist under the new rules, i.e. what is the current problem (if any) with boundary issues? If there is no existing issue, then perhaps there is no need for a new rule.

HMRC reiterated that the purpose of the consultation is to articulate the core principles of the regime in a robust manner. HMRC noted that, if it transpires that it is possible to develop something that provides a strong framework structure and scope without any need for difficult and detailed rules, then this would be welcome.

It was noted that there will probably still be a need for a specific rule on allocation, i.e. picking up the area where 'fairly represents' is uncontentious and does the job properly. Where items are bundled in the accounts, there is a need for a rule which provides that debits and credits must be allocated on a just and reasonable basis. There are two separate questions – selecting the right amounts from what has been recorded in the accounts and identifying situations where the accounts fundamentally give the 'wrong' answer for tax. The just and reasonable approach should work fine as long as it is limited to amounts which are actually in the accounts and is not extended to situations where perhaps HMRC does not agree

with the existing amounts and wants to impose other amounts. We would need one rule to give clarity of allocation and then a separate rule which to introduce any deeming.

One member queried whether people may read into the change of wording / elimination of the 'fairly represents' language some unintended purpose. It has been argued that 'fairly represents' allows one, exceptionally, to impute new amounts and this is where problems arise; the rule works fine 99% of the time. Part of the issue is that the phrase has been influenced by avoidance cases and therefore there is a need for a fresh approach. One just needs to look at different views put forward in the DCC Holdings case to understand the difficulties.

It was suggested that the approach could be 1) identify the debits and credits; 2) limit to those recorded in the Income Statement; and 3) only bring into account those in respect of LRDC matters. This is the identification and allocation test. Then separately, apply any specific rule in limited category of cases (e.g. where accounting and legal treatments do not match) where it is not appropriate to just look at the entries in the profit and loss, and there is a need to go further, e.g. deeming different scenario.

It was noted that HMRC should not underestimate the difficulty of operating a regime which carries a general override to the accounts, such as e.g. the capital allowances regime. There was general agreement that being unable to predict what might happen in the future and what changes might be required to the specific rules is not cause for building in general overrides. Avoidance cases can be dealt with separately using purpose-based tests but the basic rules should be as specific as possible.

Under the current regime, the great majority of taxpayers just take amounts from the accounts and include this number in their tax computation and generally don't need to worry about most of the rules. It was agreed that it is important that this can continue in most cases. There is then a different question as to what the regime is looking to do / what the underlying principles should be so that when there is a difficult case, it is possible to identify the appropriate outcome.

With regard to 'bundles' of LRDCs, one member asked why it might be incorrect just to take the overall result from the accounts. HMRC noted that, as drafted, s307(3) refers to loan relationships generally. However, some of the specific rules then refer to individual instruments. It was noted that the question is probably academic as it is unlikely that the approaches would give different answers, at least over time. HMRC agreed that in general it may give the same answer but, at the time, they did not definitively confirm the preferred approach.

On the subject of accounting changes, it was agreed that real issues may only be identified in 2015 and 2016 when accounts are being prepared. There is a question as to whether any changes to the tax rules to deal with new issues should be retrospective to beginning of 2015 or applicable from the date of the change.

Overall, there was a question whether it is possible to draft a rule to deal with the scoping issues, which have arisen in the past without generating significant uncertainty? HMRC need to have some conversations internally on the subject of individual versus pooled profits to help determine the way forward.

HMRC pointed out that specific rather than general rules would leave the potential scenario where there is no avoidance but the detailed rules lack the flexibility to give a sensible result. This needs to be acknowledged. One possible answer is that there is a regime TAAR to deal with same issues where HMRC is currently seeking to use 'fairly represents' and then, with regard to cases where may need to act in favour of the taxpayer (accepting that these cases will reduce under the new regime) consider including a provision which allows taxpayers to submit a claim for relief to give 'just' answer. HMRC was not attracted to this idea, but acknowledged that it might be possible to include a regulation-making power which could permit adjustments to the legislation in the light of unexpected circumstances.

Next steps

In view of the fact that the paper was released quite late, HMRC noted that they would like to give the

group the opportunity to discuss this again at the next meeting so people have had chance to consider the proposals in more detail. In particular, it would be useful to consider the examples and whether these are complete or whether there are any other scenarios requiring particular consideration which should be included. In considering the paper, the question was asked as to whether it would be reasonable to assume that the current 'fairly represents' will be narrowed. HMRC agreed that, in view of the proposed regime TAAR, this would, without prejudice, be an appropriate assumption for discussion purposes.

HMRC will try to circulate the regime schematic in advance of the next meeting so this can form the basis for discussion. It was agreed that it would be worthwhile having a discussion on this now so people can think about how it all fits together.

It was noted that the discussion papers seem to suggest that there will be a need for a number of specific anti-avoidance provisions but separately there are also proposals for a regime TAAR. HMRC said that it may be that the specific issues will be covered by the regime TAAR so it wouldn't be an additional rule. However, until more is known about how the core scope of the regime will be defined, it is difficult to know what the regime TAAR will need to cover, e.g. whether it will need to extend to 'fairly represents'.