**Modernising the taxation of corporate debt and derivative contracts**

**Minutes of Working Group 1 meeting on 19 July 2013**

**Opening statements**

HMRC opened the meeting by setting out some operating guidelines for the working party meetings. The key points were as follows.

* The meetings will be minuted. The minutes will be sent to the group leader in the first instance and he will then circulate the minutes to the group for review and comment. Once agreed, the minutes will be sent to the other working group members as there is a lot of cross-over between the groups and this should help to ensure consistency.
* HMRC emphasised that they want the process to be open and consultative. The purpose of the initial review of the minutes by the group leader is to mitigate the risk that comments made during the meeting could be taken out of context and could raise unnecessary concern among taxpayers outside the group. This review process should encourage more frank discussion within the groups as members should be less concerned about comments being misinterpreted at a later date.
* HMRC encouraged group members to discuss the relevant issues within their organisations as this should increase the breadth of views being shared and should lead to more fully informed discussion and ultimately better legislation. However, it is important to note, especially as regards the early meetings that nothing has been decided and all ideas will require full consideration before they form full proposals. Members should bear this in mind and take care not to make premature statements about direction of travel, which might cause alarm.
* It is important to note that the purpose of the groups is to discuss and consult but they cannot make decisions. Ultimately HMRC will make recommendations to Ministers. The intention is for the groups to consider all of the feasible options and ideally arrive at shared understanding as to the best option in the various areas. The goal is to find a solution which commands maximum consensus though HMRC acknowledged that universal agreement is likely to be quite difficult, especially in certain areas.
* Where there are conflicting views, it is ultimately HMRC that has to make the recommendations to Ministers. However, that advice would include, where appropriate, alternative views or options, and the advantages and disadvantages of each.
* The discussions will be framed by the Condoc itself, i.e. the document sets out the scope of the consultation process. However, this doesn't mean that the group can only consider those options which are set out in the Condoc. In many areas, the Condoc sets out open questions rather than formal proposals and HMRC is keen to hear suggestions in these areas.
* A query was raised as to whether members can send substitutes in the event that they cannot attend a particular meeting. This is not a problem as long as Karin McHardy is aware of the change in advance and as long as the alternate is fully briefed so they can participate in the discussion.
* It may be the case that the group will later be broken down into smaller groups to discuss specific topics. However, it is important for everyone to be involved in the initial discussions in each area.
* Comments made by HMRC about future possibilities should not be taken as impacting on their view of existing cases under discussion or dispute.
* HMRC noted that the consultation comprises three broad strands of activity. First, there is the consultation document itself in response to which HMRC is expecting to receive written representations from various parties. Second, the four working groups have been established to discuss the proposals in more detail. It is intended that these groups will continue to meet regularly throughout the process until the FB 2015 legislation is finalised. Finally, HMRC is holding bilateral meetings with interested groups / organisations. The intention is to generate lots of discussion and ideas. All of the strands will feed into each other.

**Timing**

* As regards the FB 2014 material, the whole process is quite compressed. HMRC will be passing initial instructions to OPC on the unallowable purposes changes over the next few weeks. The plan is to have draft legislation in time for the October WG meeting so the group can review and comment. This should provide enough time to discuss and amend the legislation in time for publication of the draft clauses in November / December. The goal of the first meeting is to understand to what extent the instructions to OPC need to be provisional and in what areas. OPC are used to dealing with uncertainty so it shouldn’t be an issue that some ideas may not be fully formed.
* With respect to FB 2015, there is a lot more material and the subject matter is far more wide-ranging. However, there is also more time available. The intention is to have visited each topic at least once by the end of 2013.
* A schedule of future meetings has been circulated. The frequency of meetings increases towards the end of the year to reflect the fact that the group is likely to be discussing the detailed wording of the FB 2014 legislation. The objective is to have discussed each of the areas under consideration so that everyone has an idea of the direction of travel.

**Unallowable purposes rule**

The view in HMRC is that the unallowable purposes rule generally works as intended but there are certain areas where the rules are not as clear as they could have been and that has led to a number of differences in interpretation. The Condoc lists various areas where issues have arisen. HMRC is looking to take this opportunity to “fix” specific aspects of the legislation to take account of experience to date.

*General points*

HMRC acknowledge that some of the issues, e.g. extent to which composite amounts recorded in the accounts can be split into their constituent parts, are likely to be discussed in a number of different contexts both within this group at a later date and in the other groups. However, given that unallowable purposes has been prioritised for FB 2014 it is necessary to have this discussion now rather than waiting for the discussion on the overall structure of the regime.

By the time the group is reviewing the draft legislation, however, there may be more clarity on the direction of travel in other areas and it may be possible to revise the draft based on progress elsewhere. There is a general question as to what extent the current detailed mechanistic anti-avoidance provisions can be replaced with a more holistic and comprehensive provision and to what extent certain individual rules will still be needed to deal with specific scenarios; the interaction between a general regime TAAR and the unallowable purpose rules needs to be part of that discussion.

The revised unallowable purpose rule is expected to survive through the FB 2015 changes though some tweaks may be needed to reflect broader changes made in FB 2015. Therefore, the 2014 amendments are not intended to be just short-term fixes but are part of a more long-term overhaul of the rule. The likely direction of travel as regards the FB 2015 changes also needs to be taken into account, e.g. the possibility that the loan relationship and derivative contract regimes will be combined. Some of the issues listed in the Condoc have only arisen in a small number of cases and HMRC acknowledged that if these issues were tested it may be that HMRC’s interpretation of the existing legislation is correct such that there would be no need to amend the provisions. However, testing these issues could take a long time and so it makes sense to eliminate any uncertainty now given that the intention is for the rule to continue beyond FB 2015.

The group asked whether it would be possible for HMRC to provide some examples of the issues they have encountered with the legislation. HMRC will endeavour to do this but there is understandable sensitivity due to the interaction with ongoing disputes in this area.

HMRC asked the group to consider where they think the boundary should lie as regards the application of the unallowable purposes provision. The object of the consultation is not for HMRC to impose its view but for all sides to consider the point and, if possible, agree on the best answer. Each group member needs to contribute to that process. HMRC asked the group to consider this question in advance of the next meeting in September.

One view put forward was that the unallowable purposes rule should be targeted only at excess debits which are created through some form of tax planning, i.e. the rule should only apply where and to the extent that incremental debits have been created over and above what would have existed absent the tax planning. This would essentially involve being more specific about how the just and reasonable counteraction would operate, and therefore should clarify the application of the provision.

There will be a number of areas where the LR / DC review interacts with other areas of the legislation and it will be important to avoid “mission creep”. The objective of this consultation is to determine the correct approach to the taxation of loan relationships and derivative contracts. To the extent the chosen route affects other areas of the tax code, HMRC will involve the relevant policy person in those areas to ensure that the new LR / DC regime fits sensibly with the other regimes.

*List of issues / proposals*

1. In situations where a debit forms part of a composite amount, it has been argued that the figure in the accounts cannot be split into its constituent parts. The objective is to make it clear that composite amounts can be unpicked and a just and reasonable remedy applied.

2. The legislation relies on a legal definition of *“related transaction”*. Taxpayers have been able to manipulate the accounting result using other instruments in conjunction with LR / DC so as to obtain a tax advantage but with no related transaction in respect of a loan relationship or derivative contract such that the unallowable purposes rules cannot be applied. The intention is to expand the definition in line with the language used in the transactions in securities legislation, i.e. anything that amounts in substance to a related transaction.

3. Taxpayers have argued that where an avoidance arrangement is funded out of a fungible pool of instruments it is not possible to attribute the “bad” purpose to an individual debt and therefore the unallowable purposes rule cannot be applied. The legislation will make it clear that the unallowable purposes rule can be applied on a just and reasonable basis across the entire pool.

4. The intention is to change the specific provision in the derivative contract rules which exempts credits as well as disallowing debits. The rule would be amended to match the loan relationship equivalent so that credits would be taxable but debits would remain non-deductible.

5. As regards the definition of tax advantage, the intention is to expand this so that the group position can be considered. It then should not matter if it is not possible to identify a specific company that has obtained an advantage. If the overall group liability has been reduced, the unallowable purposes rule may apply to any loans or derivatives entered into as part of the arrangements.

6. Finally, the intention is to amend the legislation so that a chance or opportunity of securing a tax advantage is sufficient to trigger the provisions. The language could be similar to the group mismatch scheme rules.

*Group tax advantage*

The group noted that there was nothing in the Condoc to suggest that the intention is to move away from considering the purpose of the individual borrower and queried whether this was the correct reading. There was some concern that the proposals from a few years ago around extending the scope of the unallowable purposes rule were being revisited. HMRC made it clear that this was not the case and the point around considering the group position was focused on the definition of tax advantage and not the relevant purpose for determining whether the rules applied.

It was noted that, in establishing the purpose of the individual borrower, regard may be had to all facts and circumstances including those relating to other stakeholders who were involved in the transaction. The criteria in this regard will remain the same and HMRC is not looking to extend the rules to look at group purpose. HMRC has considered whether the rules should look to the purpose of the overall arrangements (such as with anti-arbitrage) but the conclusion was to continue referring to the purpose of the individual company.

A query was raised as to how different the test will be going forward. HMRC explained that the difficulty with the current legislation is that it only applies if it is possible to identify a specific company which has obtained a tax advantage (the test is then whether one of the borrower’s purposes was to obtain that advantage). However, in some cases, while the overall tax liability of the group has decreased, there is arguably no one company that has obtained an advantage and so the rules cannot be applied.

An example was given of transferring an interest-bearing loan into a loss-making company. The transferor no longer has a source of income and therefore it is reasonable to have no tax liability and the transferee is in the same position before and after the transaction so cannot be said to have obtained a tax advantage. However, overall, the group is paying less tax. If such a transaction involves incremental debits being created, then HMRC may, subject to the specific facts and circumstances, seek to apply the unallowable purposes provision to those incremental debits. HMRC emphasised that, if such a transaction is achieved without creating new debits, then the unallowable purposes rule should not apply as long as the borrower continues to have a commercial purpose for the original borrowing.

A question was asked as to whether the proposals in this regard were being driven by recent discussions in relation to the application of the provisions to CFC financing. HMRC agreed that issues in this area may be relevant but emphasised that there were a number of other situations where this issue had arisen in practice.

A focus of any change to the legislation would be the definition of tax advantage. This could be extended for the purposes of section 441. However, looking at the specific wording is the second step. The first objective is to establish what the rule should be targeted at and what should be outside its scope.

*Loss refreshing / group relief*

There was a lengthy discussion about the specific example used to illustrate the issue with the rules as many of the group felt that standard loss planning should not be the target of the provisions. There was discussion of how the unallowable purposes rule might be applicable in circumstances where the an original loss arose from commercial transactions but subsequent transactions involving loan relationships were designed to ensure that the loss could be offset against profits arising elsewhere in the group at a different time.

The difficulty in these circumstances is that, as the rules are currently drafted, it is not always possible to target any new debits because the main purpose of the company in entering into the borrowing is not to create a tax advantage for itself in the form of the debit but rather to reduce the overall group liability by moving the credits into a loss-making company. The intention is to amend the provisions so that, if a company’s only purpose in entering into a loan is to reduce the group’s overall liability to tax, that loan can be targeted under section 441.

The group also discussed the related issue of loss refreshing. It was suggested that there is some lack of clarity in HMRC’s view of situations where a group chooses to make a new loan (which is wholly commercial and would be made in any event) from a loss-making company (rather than a profit-making company) thereby converting the brought forward losses into current year debits in another company. It is unclear whether or not this is acceptable planning. In practice, taxpayers have to rely on the just and reasonable rule to deal with challenges from HMRC but the feeling is that in many cases the rule should not be invoked at all as the borrower is acting wholly commercially.

It was agreed that it is important to consider the broad policy intention in determining the scope of the unallowable purposes rule. As regards group relief, it was suggested that one might question the extent to which the policy choices behind the existing restrictions on the availability of relief remain valid. HMRC said that the original policy behind various different pieces of legislation might potentially be instructive, but would not necessarily determine policy choices to be made in the current review. It was important to bear in mind that the condoc proposals were aimed at dealing with some specific issues with the unallowable purpose rules; there was not a mandate to revisit existing policy in other areas of the corporation tax code. HMRC asked the group to consider, with that point in mind, what they believe the scope of the unallowable rules should be and what should fall outside the rule, and why. HMRC also agreed to see if a policy person responsible for the area of group relief and loss usage would be able to attend the next meeting. HMRC noted that the overlap in this area had already been identified.

*Thinning out*

The group also raised the issue of the application of the unallowable purposes rule to loans used to fund the payment of a dividend. HMRC guidance suggests that this is not a problem but group members have seen recent cases where section 441 has been used to challenge the interest deduction. This raises a general point around the choice between debt and equity and whether this is a commercial or tax choice.

HMRC noted that there were a number of discussions ongoing internally on this issue at the moment and it would make sense to defer any discussions on this within the working groups until the internal discussions had reached a conclusion. HMRC will relay any outcomes to the working groups and the issue can then be discussed as appropriate.

*Derivative contracts*

The group noted that the changes proposed in relation to derivative contracts appear to be more fundamental and are just not designed to ensure that the rules work as always intended. HMRC agreed that this does represent a departure as they have found the derivative contracts rule to be less useful. It was assumed when the rule was originally drafted that derivative contracts were more likely to produce debits but this is not always the case.

The group expressed some concern around the proposed approach as it might result in a tax liability arising even though there was no economic profit. It was noted that this may just be the consequence of using a derivative contract for an unallowable purpose. The group accepted this but noted that there will always be disagreements as to where the correct boundary lies between acceptable and unacceptable and, given this debate, they encouraged HMRC not to be penal and effectively impose a double charge but instead just eliminate the tax advantage.

It was suggested that the proposals in relation to foreign exchange may make this less of an issue as it may be the case that the movements would simply fall outside the scope of tax. However, the group was not convinced that this would make a significant difference in light of the accounting proposals in relation to the fair value attributable to own credit risk and the fact that even the interest rate component of a fair value adjustment can be quite substantial.

*Timing*

It was reiterated that this is a FB 2014 priority. However, if it becomes impossible to resolve all issues in time for FB 2014, it is not the case that the provision cannot be revisited in 2015 and indeed as previously acknowledged some tweaks may be needed in any case to reflect FB 2015 changes. However, the hope is that all of the issues can be dealt with in FB 2014.

The current expectation is that any amended unallowable purpose rules will apply from Royal Assent and not from the publication of the FB 2014 clauses in the Autumn. There is an overriding question as to transitional issues but this is across the regime.

*Next steps*

* Group to consider where the boundary should lie as regards the application of the unallowable purposes provision and be prepared to discuss this at the September meeting.
* HMRC would welcome the opportunity to consider any proposals in advance of this meeting so group members are encouraged to share thoughts by email.
* HMRC will circulate an agenda for September’ s meeting – it seems that there is more to discuss re unallowable purposes. The group can then feed in re specific agenda points.