Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 3 meeting on 11 April 2014
100 Parliament Street 10.00 to 12:00

Attendees:

Andrei Belinski, Centrica

Paul Freeman, KPMG

Victoria Heard, KPMG

David Hill, Grant Thornton

Matthew Hodkin, Norton Rose

Chris Kell, HSBC

John Lindsay, Linklaters / CIOT

Anne Murphy, Legal & General / ABI

Chiunga Ng, Deloitte

Kieran Sweeney, LBG

Fiona Thomson, Ernst & Young

Stephen Weston, Deloitte

Charles Yorke, Allen & Overy

Graham Williams, PwC

Richard Daniel, HMRC

Andrew Gribble, HMRC

Rob Harvey, HMRC

Roger Muray, HMRC

Andy Stewardson, HMRC

Apologies:

Jackie Latham, Rolls Royce

David Boneham, Deloitte

1 Introduction

Technical note

1.1 A technical note had been published the day before the meeting (i.e. 10 April 2014). This largely reflected working group discussions and so was not expected to have contained any major surprises.

WG3 priorities

1.2 HMRC had circulated a summary of the priorities for WG3. The purpose of the current meeting was to briefly discuss each of these priority areas.

2 Priority 1 – initial changes to secondary legislation

Timetable

2.1 It was still intended to make these changes to the Disregard and COAP regulations ahead of the summer recess.

Current proposals

2.2 There were two new proposals in comparison to the position previously considered by the full working group. Firstly, it was intended to recast elections under Regulation 4A so that these become prospective, but may be made at any time. Secondly, it was intended to remove the restriction in Regulation 3(1A) excluding non-lending money debts from the scope of the matching rules.

2.3 The other proposals as set out in the priorities document had been discussed in a sub-group meeting. HMRC hoped to reach a position in which extended time limits (particularly for SMEs) could be put in place for elections under Regulation 6, which would also be made "elect-in" rather than "elect-out", as discussed at the previous working group meeting. This would require protection to avoid exploitation of the extended time limits.

2.4 The basic intention of HMRC's proposals was that if a hedging arrangement was effective for accounting purposes then it would also be effective for tax purposes. If an economic hedge did not operate as such for accounting purposes then it should still be possible for this to act as a tax-effective hedge, but it would be necessary to opt into this treatment.

2.5 Thought would need to be given to transitional arrangements; the intention here would be to give continuity to companies already subject to adjustments under the Disregard Regulations.

3 Priority 2 – changes to more closely follow accounts

Relationship with WG1

3.1 It was noted that there was some overlap with the work being undertaken within WG1. In this context it was noted that following discussions at WG1 it was intended to move away from a situation in which either HMRC or taxpayers were placing significant reliance on the "fairly represents" provision, i.e. the expectation was that the accounts would be followed for tax in the absence of a specific statutory rule to the contrary.

Equity instruments

3.2 In connection with general move to tax/relieve only amounts recognised in profit and loss in most cases, it was proposed to repeal ss321 & 605 CTA 2009. This should result in no relief being given for equity instruments, even if legally debt.

3.3 It was noted that HMRC did not anticipate any impact of this change for regulatory capital instruments issued by banks, as these were now covered by separate

legislation. HMRC questioned whether it was necessary to grandfather existing instruments not covered by this legislation.

3.4 This approach raised concerns for some non-HMRC participants on the basis that there was a *prima facie* risk that this change could significantly impact the tax profile of existing commercial arrangements which may be difficult to unwind. HMRC noted that they had not seen any significant evidence of such arrangements and that it would therefore be helpful if some actual examples (anonymised where necessary) could be provided so that the extent of any problem could be properly determined. Effectively it would require an instrument to be wholly equity, with discretionary coupons and the debt only due on the winding up of the company.

3.5 It was also noted that consideration may need to be given as to whether the proposals might cause issues for smaller banks in groups with a mixture of banking and non-banking entities.

Transition / Interaction with COAP Regulations

3.6 The interaction with the COAP Regulations was identified as a potentially problematic area.

3.7 An example of the type of difficulty envisaged was where an amount was recognised in the income statement pre-transition (and hence taxed), but post-transition was treated as recognised in equity and then subsequently recycled to the income statement (and thus taxed again). The rules would need to be drafted so as to exclude such potential double taxation/deduction.

4 Priority 3 – fair value accounting

Connected party debt

4.1 In addition to the points set out in the priorities document, it was noted that it was intended to relax s349 CTA 2009 to allow fair value adjustments to the carrying value of connected party debt to be respected for tax purposes in cases where that debt was designated as a fair value hedge.

5 Priority 4 – foreign exchange

Overseas branches

5.1 It was proposed to refresh the foreign exchange rules as set out in the priorities document. In addition it was noted that it was intended to clarify the operation of designated currency elections for overseas branches.

6 Priority 5 – derivative contracts

Scope of regime

6.1 It was proposed to revisit the definition of “relevant contract” in order to align this more closely with the definitions in FSMA 2000.

6.2 It was also proposed to revisit the accountancy conditions in order to reflect the move to new UK GAAP/IFRS and to consider whether the modifications to the basic accountancy condition remained useful.

6.3 It was intended to remove the existing exclusion for options/futures over intangible fixed assets. This would bring such instruments within the scope of the derivatives regime and so, in particular, allow the machinery governing hedging transactions to apply to them.

Issuers of convertibles

6.4 Currently if a group issued a convertible instrument this would be split for accounting purposes between a liability and either an equity instrument or a derivative instrument. This split was respected for tax purposes, with potentially significantly different tax consequences depending on whether this resulted in an equity instrument or a derivative contract being recognised.

6.5 It was intended that in certain cases the tax treatment of derivatives embedded in convertible instruments should be modified to align it with the tax treatment of equity instruments, i.e. to treat the derivatives as tax nothings. The current proposal was that this modified treatment should apply when the embedded fell to be treated as a derivative rather than as an equity instrument because of a cash settlement option or the retranslation of the notional prevented the conversion option being "fixed-for-fixed". It was also intended that this change should be extended to cover issuances by SPVs.

Holders of convertibles

6.6 It was intended to repeal the capital gains charges on fair value movements on embedded derivatives recognised by the holder of a convertible instrument. New provisions would be introduced to treat the debits and credits as non-taxable in cases where, broadly, the current rules would treat them as within the scope of the SSE.

7 Priority 6 – Parts 5 and 7

Alignment of wording

7.1 Although a full amalgamation of Parts 5 and 7 was no longer a priority item in the short term, it was intended to align the wording where appropriate.