Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 3 meeting on 6 December 2013
1 Horse Guards 10.00 to 12:00

Attendees:

Andrei Belinski, Centrica

David Boneham, Deloitte

Paul Freeman, KPMG

Victoria Heard, KPMG

David Hill, Grant Thornton

Chris Kell, HSBC

John Lindsay, Linklaters / CIOT

Anne Murphy, Legal & General / ABI

Kieran Sweeney, LBG

Stephen Weston, Deloitte

Charles Yorke, Allen & Overy

Jackie Latham, Rolls Royce

Graham Williams, PwC

Richard Daniel, HMRC

Rob Harvey, HMRC

Chris Murricane, HMRC

Ros Shaw, HMRC

Andy Stewardson, HMRC

Apologies:

Matthew Hodkin, Norton Rose

Fiona Thomson, Ernst & Young

1 **Administration and points from earlier meetings**

Working group minutes

1.1 The draft minutes of the WG3 meeting on 8 November were currently being reviewed by HMRC and would be circulated shortly.

Response to consultation process

1.2 The response document to the formal consultation would be published on 10 December 2013, at same time as the draft legislation for inclusion in Finance Bill 2014.

FRS 101/102

1.3 HMRC were proposing to publish a paper on the key tax implications of the transition to FRS 101/102. The intention was that this should be available by the end of the year.

2 Definitions

Background

2.1 HMRC were not proposing to make changes to the definitions of either a "loan relationship" or a "derivative contract". They were however interested in understanding if any problems existed with these in practice.

"Loan relationship"

2.2 It was noted that the decision of the First-Tier Tribunal *in MJP Media Services Ltd v Revenue and Customs Commissioners*[1] had created uncertainty about the effect of the requirement that a debt must arise "from a transaction for the lending of money" for it to be a loan relationship[2]. In particular, there was now potentially a doubt whether, if A settled a debt due to C from B, the resultant liability from B to A would be a loan relationship. This doubt had not been adequately resolved by the subsequent decisions of either the Upper-Tier Tribunal[3] or the Court of Appeal[4] and the uncertainty had been increased by an apparently conflicting decision of the First-Tier Tribunal on other provisions[5].

2.3 The uncertainty in this area typically became a concern when analysing the tax implications of debt waivers as it created a risk that the statutory exemptions in the loan relationship regime from taxing a credit in the debtor company would not apply. Members of the group noted that this created difficulties which needed time and effort to resolve. Whilst it was in some cases possible to either conclude that the credit was non-taxable regardless (for example, as being a capital amount not derived from any asset) or to take steps to unambiguously bring the debt within the regime, it would be helpful if the opportunity could be taken to amend the legislation so as to eliminate the uncertainty causing the problem.

2.4 Although this issue was most commonly seen in the context of debt waivers it was occasionally of wider relevance. For example, in determining whether the group continuity rules[6] applied to a particular balance or in analysing the impact of the exclusion for deemed loan relationships from the forex matching rules[7]. This meant that it was in issue that would be best dealt with by clarifying the definition of "loan relationship" rather than by amending the scope of the individual provisions within the regime.

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[1] [2010] UKFTT 298 (TC)
[2] S302(1) CTA 2009
[3] [2011] UKUT 100 (TCC)
[4] [2012] EWCA Civ 1588
[5] *Aspect Capital Ltd v Revenue and Customs Commissioners* [2012] UKFTT 430 (TC)
[6] Chapter 4 of Part 5 CTA 2009
[7] SI 2004/3256 Regulation 3(1A)

2.5 HMRC noted the various comments made. Whilst this was not a WG3 issue they would give consideration to how the concerns raised might be taken forward.

"Derivative contract"

2.6 In the context of which contracts were "relevant contracts" for the purposes of the definition of "derivative contract"[8], it was noted that some participants had experienced differing approaches from HMRC in applying the criteria for a contract to be a "contract for differences"[9]. In particular, some Inspectors had sought to read this as a purpose test. This was, however, felt to reflect a need for additional clarity in guidance rather than a change to the legislation.

2.7 The accounting test included within the definition of "derivative contract" was felt to potentially merit further consideration. For example, were the deeming provisions for 'hybrid derivatives' still appropriate? It was under understood that the disregard of the accounting requirement for no initial net investment[10] originally stemmed from a desire to block certain "disguised interest" schemes; given the introduction of separate legislation to specifically target such schemes did this modification of accounting test still perform any useful function? Whilst there was no similar change in circumstances in relation to the extension of the accounting test for contracts with an underlying subject matter of commodities[11], it was noted that this could give rise to uncertainty in practice (particularly with regard to terms embedded in supplier contracts) and may therefore be worth reviewing.

2.8 The exclusions from the definition of "derivative contracts" for contracts with particular underlying subject matter were felt by some participants to be confused.[12] For example, it was hard to see why an option or a future should be excluded but not a contract for differences with the same underlying subject matter. It was noted that when the legislation was originally drafted there had been a policy intention to differentiate situations in which there was a delivery of an underlying subject matter; it was not clear however if this continued to be an explicit policy intention.

2.9 Also in relation to the "underlying subject matter" exclusions, it was observed that the various share exclusions in some cases appeared arbitrary. The link in s591(5) CTA 2009 to the "substantial shareholding" rules was also thought to be unhelpfully ambiguous in its application.

2.10 Thinking more broadly about the scope of the derivative contracts rules, the difference in treatment between the issue of free-standing share warrants (attracting a tax charge under s144 TCGA 1992) and equivalent rights embedded within a convertible (not attracting any charge on issue) was raised as an unhelpful anomaly. It was accepted, however, that this was arguably more of a problem with the operation of s144 TCGA 1992 and hence outside the scope of the working group's remit.

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[8] S576 CTA 2009
[9] S582 CTA 2009
[10] S579(1)(b) CTA 2009
[11] S579(2)(a) CTA 2009
[12] S589 CTA 2009

3 Consultation document proposals

Property derivatives

3.1 It was proposed to abolish the current special regime for property derivatives. The consultation responses received had not indicated any widespread opposition to this proposal, although a small number of taxpayers were using the regime. HMRC did not think that the change was likely to have a major impact.

Holders of convertibles

3.2 It was noted that accounting changes would make bifurcation less prevalent going forward. No major concerns had been raised over the proposal to reflect this change for tax purposes.

Issuers of convertibles

3.3 The consultation had proposed to broadly retain the existing rules.

3.4 Responses to this proposal had largely concerned instruments with similar structures which nonetheless attracted differing accounting and hence tax treatments. A common example was an instrument which was ultimately convertible into shares in the top company of a group. Whether the conversion rights fell to be accounted for as an embedded equity instrument or as an embedded derivative varied according to which group entity was used as the issuance vehicle and the precise legal structure. This in turn led to differing tax consequences for situations which, from a group perspective at least, had the same economic consequences. Linked in with this was the earlier point about the scope of the derivative rules and the application of s144 TCGA to issues of warrants.

3.5 HMRC were sympathetic to looking at the options for addressing these kinds of anomalies, but noted that any potential cost to the exchequer would be a relevant factor in doing this.

3.6 Some consultation responses had noted that the proposals created a risk of asymmetry in cases where convertible instruments were issued intra-group. From HMRC's perspective the group mismatch rules in particular gave some comfort that there would be limited scope for deliberate exploitation of such asymmetry for tax avoidance purposes. From the perspective of taxpayers, however, it was noted that there was limited protection against any unintended adverse impact of any asymmetry, although HMRC questioned to what extent commercial intra-group issues of convertible instruments actually took place and hence whether this was a significant issue in practice. The non-HMRC participants took the view that although uncommon such situations did arise commercially (one example cited was of a takeover in which convertible debt was acquired but not immediately cancelled) and hence that some further consideration of how to deal with this may be justified.

Index-linked gilts

3.7 Some proposals had been included in the consultation document, but these were now expected to be dropped.

4 **Way forward**

Following the P&L

4.1 HMRC felt that there was a broad consensus in favour of the general approach, notwithstanding some concern on some of the detailed rules. HMRC would therefore look to articulate their thinking on these specific points more clearly ahead of drafting legislation.

Hedging

4.2 HMRC felt that they had a reasonable handle on the dynamics and interaction between the different options which they looked forward into taking into further discussions in the following year.

Forex

4.3 It was still possible that either the existing approach or that set out in the consultation could ultimately be adopted. A summary of the options was to be prepared by one of the non-HMRC participants in order to help move the discussion forward.

Secondary legislation

4.4 The possible secondary legislation discussed in the working group meetings was yet to be agreed with the relevant Ministers. The process to put this legislation in place was however still expected to be completed within the course of the next six months. Some thought would need to be given to commencement provisions and it was not certain that early adopters would be able to take the benefit of the changes to be made by the secondary legislation. This was not regarded as a significant issue, however, as those companies which were faced with the difficulties the legislation was designed to address would for that reason be unlikely to be early adopters.