

Minutes of WG2 Meeting

10am – 11am Thursday 14 November 2013

HMRC, Right Auditorium, 1 Horse Guards Road, London, SW1A 2HQ

Attendees

Ann Brennan (GE / BBA Rep)
Vincent Maguire (Clifford Chance)
David Boneham (CIOT / Deloitte)
Lara Okukenu (Deloitte)
Graham Williams (PwC)
Andrew Seagren (KPMG)
Lydia Challen (Allen & Overy)
Catherine Linsey (ECI Partners)
Paul Baldwin (FTI Consulting)
Nikol Davies (Taylor Wessing)
Jonathan Richards (Ernst & Young)
Stuart Sinclair (Bingham McCutchen)
Andrew Hastie (LBG)
Tom Cartwright (Pinsent Masons)

(collectively the “group”)

Tony Sadler (HMRC) - **Chairman**
Mark Lafone (HMRC)
Richard Daniel (HMRC)
Roger Bath (HMRC)
Andrew Scott (HMRC)
Andy Stewardson (HMRC)

(collectively “HMRC”)

Apologies

Paul Miller (Ashurts)
Alex Jupp (Skadden)
Adam Blakemore (Cadwalader)
Kathryn Hiddleston (Grant Thornton)

1. Introductions and background

HMRC opened the meeting by summarising that the intention of the meeting was to focus on connected party debt.

In advance of this, HMRC asked whether there were any questions or comments the group had in the context of the remaining three WG2 agenda items (i.e. group continuity, partnerships and debt restructuring). These questions /comments have been summarised below.

2. Group Continuity

A member of the group commented that in the previous meeting, it had been agreed that HMRC were to produce a draft paper setting out their thoughts on what they considered to be the intention behind the group continuity rules including examples of scenarios where they do not consider this intention to be satisfied for this to be discussed at the next working party group.

HMRC confirmed that this was still the intention and that they would like further time to reflect specific points e.g. asymmetry, exit charges etc, especially in the context of the general sentiment for minimal change.

3. Partnerships

HMRC apologised that they were not yet in a position to share draft legislation, commenting that this had been due to difficulties freeing up parliamentary counsel.

Members of the group expressed concern that the timetable for draft legislation to be included in the Finance Bill 2014 would mean that the group would not have sufficient time to review. In particular, it was noted that given HMRC’s commitment to publication, any views concerning the fundamental principles of such drafting would not be given due consideration.

HMRC reassured the group that whilst they will make every effort to adhere to the consultation timetable, they would not publish legislation without due consideration being made. With this in

mind, it was not completely inconceivable that given timings, draft legislation would not be included in the Finance Bill 2014.

HMRC concluded that they are however hopeful that they would be in a position to produce draft legislation such that at least one WG2 group meeting could be held to discuss this in detail (with draft legislation having been sent to the group in advance of that meeting).

4. Other working party groups

A member of the group queried whether there were any matters relevant from the other working party groups.

HMRC and certain members of the group commented that generally they could not think of any matter that directly impinged on WG2 matters other than the WG3 discussions regarding the interaction between the “follow the accounts” treatment and designated fair value hedges, which it was felt should be considered in the context of the WG2 connected party debt discussions.

5. Connected Party Rules

The remaining portion of the meeting focussed on HMRC’s connected party debt discussion paper which had been circulated on 13 November 2013.

HMRC provided the following summary comments regarding their approach to preparing the paper:

- Chapters 5 and 6 of Part 5 require parties to a connected company relationship to use an amortised cost basis of accounting; a rule which derives from the pre 2005 requirement for connected companies to use an authorised accruals method.
- In many cases, this gives rise to legislative and computational complexity as companies move away from the principle of “following the accounts”.
- In drafting their discussion paper, HMRC therefore sought to address the scenario where the statutory requirement in section 349 was removed and instead tax follows accounts. This resulted in the need to consider further two principal areas where the treatment of connected party debt could differ to that of connected party a) impairments and b) debt releases.
- Members of the group questioned whether HMRC would be content with intra-group mis-matches from period to period for example in the scenario where company A used an accruals basis of accounting and company B used fair value basis of accounting. HMRC commented that this may be an area of mismatch that they were able to live with, however would like to the opportunity to consider further.
- There was also limited discussion regarding section 352 and whether its scope should be limited to impairments only (thereby requiring dissection of the debit recognised for accounting purposes).

Impairments

HMRC’s main concern regarding connected company debt and impairments would be the need to protect the Exchequer from the intrinsic asymmetry that arises.

HMRC commented that they would therefore want to continue to deny debits for impairments on connected company debt and that whilst this would have no impact on companies applying an amortised cost basis of accounting, this would impact companies applying a fair value

accounting. In such a case, an additional provision would be required to deny fair value debits relating to underlying impairment.

Members of the group commented that whilst they could see that such a rule would be required to protect the Exchequer against asymmetry, the proposal would require companies using fair value accounting to dissect the fair value movements to ascertain what amount (if any) related to underlying impairments.

It was felt that this practice would be unfamiliar with companies and that even in the case where it were not unfamiliar, it might not constitute readily available information and could involve a significant amount of subjectivity.

It was therefore questioned whether this approach actually allowed for simplification or simply replaced one onerous rule with another.

In response to this, HMRC agreed that the proposal may not be any less onerous, but questioned whether it could have the benefit of impacting fewer people on the basis that companies were broadly more likely to apply an amortised cost basis of accounting to financial assets.

Members of the group agreed that this was probably a fair conclusion on the basis that it was likely a small proportion applying fair value accounting on connected party debt and following this, an even smaller proportion suffering deterioration in the debtor company's worthiness.

In light of this, HMRC requested that WG2 give further thought as to whether in their view, the follow the accounts proposal (except in the context of fair value accounting) could be viable in practice.

Debt Releases

HMRC commented that, as with impairments, the main concern regarding debt releases would be the need to protect the Exchequer from any asymmetry and that this was currently achieved by neither taxing nor relieving the debt releases between connected companies.

HMRC's discussion paper therefore explored whether symmetry could instead be achieved by following the accounts e.g. taxing and relieving such debt releases, with an additional override to ensure that the debits brought into account did not exceed the credits to be brought into account.

HMRC described how this would work in practice using Example 1 as set out in the discussion paper:

Both companies use amortised costs basis in the context of a connected company loan of 100. The creditor company recognises an impairment of 10 each year for 3 years. In year 4, the debt is written off and the creditor recognises a loss of 70.

Under the proposal, for tax purposes the creditor would be denied relief for the 30 impairment and be allowed 70 in respect of the release. The debtor would recognise a profit on release of 100 but its loan relationship credit would be restricted to 70.

A member of the group commented that whilst the proposal would appear to work in the context of UK-UK transactions, it could result in asymmetry in a cross border context for example where the debtor company was UK tax resident and the creditor company non-UK tax resident.

In addition, it was highlighted that the loan relationship test for "connection" is broader than the group relief test which could result in stranded taxable credits not available for offset against the relievable debit.

The proposal could cause particular concern in the context of commercial corporate rescue arrangements whereby a creditor would be provided with significant leverage in potentially forcing a taxable credit in the debtor company.

It was therefore questioned whether it was worthwhile exploring the debt release proposal further. This was on the basis that the above such points were felt quite fundamental.

HMRC whilst acknowledging this concern encouraged WG2 to revert with their views on this proposal also.

6. Next steps & Timing

Debt Restructuring

HMRC to consider draft debt restructuring note in advance of the next WG2 meeting.

Partnerships

HMRC to circulate a draft of the proposed legislation on the partnership rules for this to be considered in greater detail in due course.

Group Continuity

HMRC to produce a draft paper setting out their thoughts on what they consider to be the intention behind the group continuity rules including examples of scenarios where they do not consider this intention to be satisfied.