

Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 3 meeting on 4 October 2013
1 Horse Guards 9:00 to 11:30

Attendees:

Andrei Belinski, Centrica
David Boneham, Deloitte / CIOT
Neil Edwards, PwC
Paul Freeman, KPMG
David Hill, Grant Thornton
Matthew Hodkin, Norton Rose
Chris Kell, HSBC
Jackie Latham, Rolls-Royce
John Lindsay, Linklaters
Anne Murphy, Legal & General / ABI
Chris Murphy, KPMG
Kieran Sweeney, LBG
Fiona Thomson, Ernst & Young
Richard Daniel, HMRC
Andy Stewardson, HMRC
Roger Bath, HMRC

1 Administration and points from earlier meetings

Working group minutes

- 1.1 HMRC confirmed that minutes from the various working group meetings were in the process of being published online. These would be linked from the page with the original consultation document.
- 1.2 The draft minutes of the previous WG3 meetings had been circulated and no points had been raised; these would therefore be published shortly.

Response to consultation process

- 1.3 The responses received in the course of the formal consultation were still being considered. It was anticipated that an initial response to these would be given at the time of the Autumn Statement, although on some aspects of the proposed changes that may simply be a statement that the underlying policy decisions are still to be made.

Current priorities

- 1.4 From HMRC's perspective addressing any issues arising from the transition to FRS 101/102 was perceived as the most urgent of the areas within the remit of WG3. In light of discussions so far HMRC were currently of the view that only minimal changes should be made ahead of transition. These were likely to take the form of amendments to the Change of Accounting Practice ("COAP") and

Disregard Regulations (with the focus being on “tidying” the legislation to increase its usability, rather than substantive changes in how it operates). As part of this they would look at the elections under regulation 6 of the Disregard Regulations. In addition, they would be looking as to whether any changes are required to address the forex issues with “permanent-as-equity” debt discussed in the previous meeting. The expectation was that any secondary legislation required should enter the parliamentary process in the first half of 2014 and would be in force no later than 1 January 2015. As with all of the working group discussions, this would be subject to ministerial agreement.

- 1.5 HMRC were aware that there were issues which could theoretically arise on transition in relation to convertible instruments. In practice, however, based on the feedback at the previous meeting, the incidence of such issues was not expected to be high. HMRC would continue to monitor this and other issues, but the expectation was that they would not be looking taking action to address this prior to transition.

Undesignated hedges

- 1.6 A question was raised regarding HMRC’s proposals for the future of the Disregard Regulations and, in particular, the treatment of undesignated hedges. The background to this question was that there was a concern that unless a company took action prior to 1 January 2014 to put the necessary documentation in place, then it would not be open to them to treat arrangements as designated hedges on adoption of new UK GAAP from 1 January 2015 without there being a risk of significant hedge ineffectiveness arising. If, as was suggested in the consultation document, undesignated hedges would largely cease to be effective for tax purposes from 1 January 2016, then companies potentially needed to take action very quickly to avoid potential tax volatility in 2016 and subsequent years. There was a concern among the non-HMRC participants that many potentially affected companies were simply unaware of the issues and that even those companies which were aware did not have the clear guidance needed to make a properly informed decision. This could represent a large population of companies who are required to adopt IFRS, FRS 101 or FRS 102 by 2015. In light of this the non-HMRC participants were keen that there should be a clear public statement of the Government’s long-term policy in this area to give a degree of certainty to taxpayers and advisers.
- 1.7 The HMRC participants confirmed that there was no desire to cause unnecessary problems for companies who are currently assessing whether to designate a hedging relationship for accounting purposes. Furthermore, it was not HMRC’s intention that a company which makes a decision now (or has done so in the past) as to whether to designate a hedging relationship should be disadvantaged if, in the future, the tax rules are amended to tie the tax rules in with the accounting treatment. HMRC thought that it should be relatively straight forward to grandfather the current approach for existing hedging instruments, with any changes applying only to new instruments. Non-HMRC participants thought that this assurance was useful and would help address the immediate concern.
- 1.8 The policy decision on the long term treatment of undesignated hedges was yet to be made, however, and the longer term position was therefore necessarily unclear. In this context, HMRC noted that the Disregard Regulations existed in part because of a desire to preserve a level playing field between UK GAAP and IFRS companies at the point IFRS accounting became an option for UK companies. The changes that were now being made to UK GAAP meant that it was no longer clear that the Disregard Regulations were needed to achieve this

result. Moreover, the need to ensure that undesignated hedges remained effective for tax purposes was felt to significantly increase the complexity of the legislation – the desire for simplification therefore provided an incentive for not retaining the Disregard Regulations in their current form in the long term.

- 1.9 The non-HMRC participants requested that HMRC still consider what further could be done to provide some certainty to taxpayers in this area. A request was also made for an appropriate statement to be made in conjunction with the Autumn Statement. The HMRC participants agreed to look into what was possible here.

Timing of new legislation coming into effect

- 1.10 In terms of the main proposals in the consultation document – both in this work stream and across the board - there was currently no settled view on when or how the various proposed changes should come into effect. For example, it was potentially an open question whether changes made in Finance Bill 2015 should take effect from 1 January 2016 or for accounting periods commencing on or after 1 January 2016.
- 1.11 Most non-HMRC participants expressed a preference for the latter as being more straightforward from a compliance perspective. It was thought helpful if the changes to the rules would take effect in a period after the period in which a company would be required to transition to new UK GAAP. HMRC saw that applying it to accounting periods after, say, 1 January 2016 would be the simplest approach and should mean that companies would not have significant tax and accounting changes in the same period. HMRC did have certain concerns around the risk of attempted accounting date manipulation which were acknowledged (for example around forex), although these risks may be able to be addressed directly.

Perpetual debt

- 1.12 HMRC noted that it remained their intention that such instruments should be prospectively excluded from the loan relationship regime, notwithstanding the comments made by the non-HMRC participants at the previous meeting. HMRC's view was that outside the banking and insurance sectors (for which special rules were proposed) such instruments were not widely used, but they were happy to discuss this further with any interested parties.
- 1.13 HMRC was aware of a concern about the treatment of existing instruments, and reiterated that the proposed change was for this exclusion to apply to newly issued instruments only. HMRC had no intention to change the treatment of perpetual debt already in existence. The meeting notes for the September meeting had further explanation on this area.

2 Foreign exchange gains and losses

Background

- 2.1 HMRC began by noting that the taxation of foreign exchange had persistently been a “high risk” area for avoidance, notwithstanding the introduction of increasingly complex anti-avoidance legislation. It was moreover an area which remained prone to generating unintended and anomalous results, both from the perspective of HMRC and taxpayers. Problems (both unintentional and as a

result of avoidance activity) were particularly associated with non-trading companies and also cross-border financing (forex matching and cross-border loans).

- 2.2 In light of these ongoing difficulties it was HMRC's view that it was an appropriate time to think about the whole approach taken to the taxation of foreign exchange. In particular, it was proposed to move away from an approach of taxing all foreign exchange gains and losses unless specifically excluded and instead adopt an approach under which only specified exchange gains and losses were brought into tax. This should remove the incentive for avoidance, reduce the incidence of anomalous or asymmetric treatment, and allow for some simplification of the legislation. It would also make it easier for multinational companies to finance their overseas operations based on commercial objectives, rather than having to undertake particular structures to avoid tax volatility on exchange movements.

Those exchange gains and losses which it was currently proposed should be taxed were set out in the consultation document, but HMRC were interested to understand if anything else should be specifically included.

Economic gains and losses

- 2.3 There was some concern from the non-HMRC participants that the exclusion of non-trading foreign exchange gains and losses would lead to economic gains and losses being left out of account. For example, if the non-trading holding company of a group was to borrow in a foreign currency to take advantage of better interest rates or other favourable terms and suffered a foreign exchange loss on the loan, then the effect of the proposals would be to deny any tax relief for what appeared to be a commercial economic loss.
- 2.4 The HMRC participants questioned the extent to which such a situation was likely to arise in practice without some natural hedge at a group level that would justify excluding relief for the loss. It was noted, however, that facts of the example given broadly resembled those in *Beauchamp (H M Inspector of Taxes) v F W Woolworth plc* 61 TC 542 and so whilst possibly unusual were certainly not unknown.
- 2.5 The HMRC participants also questioned whether exchange gains and losses conceptually fell to be automatically regarded as economic gains and losses. The quantum of such gains and losses (and indeed their existence in the first place) was arguably just a function of the choice of the currency used to draw up accounts. The functional currency of a particular company was dependent on particular factors, and could for example be different to the functional currency of the ultimate parent company in the group. Furthermore, exchange gains and losses can already fall out of account, either through the operation of specific tax rules, or simply (on a group basis) as a result the retranslation of a foreign operation with a different functional currency. Given this it was not clear that from a policy perspective the default position should be to bring such gains and losses into account.
- 2.6 This analysis was strongly challenged by some of the non-HMRC participants, disagreeing that the fact that exchange gains and losses depended on a choice of currency should be a relevant factor in determining whether or not an economic gain or loss existed. It was further noted that in practice GAAP did not permit companies a free choice of which currency to use for accounting purposes and so this was not a case in which gains and losses should be perceived as innately artificial because essentially within taxpayers' control. HMRC noted in the context of a trading company there

were often strong indicators as to a company's functional currency. However, in the context of an investment company, the functional currency will often be dictated by the functional currency of its parent.

Potential behavioural changes

- 2.7 Some non-HMRC participants also raised the question of whether the proposals might cause behavioural change and whether this would be regarded as acceptable from a policy perspective. For example, UK companies may increasingly seek overseas debt funding denominated in currencies expected to depreciate against sterling. Such loans would typically carry a high coupon and whilst the economic cost of this coupon should be offset by the anticipated exchange gain, from a tax perspective the current proposals would in many cases mean that relief was given for the coupon whilst the gain was treated as exempt.
- 2.8 The HMRC participants acknowledged that there could be a risk of such behavioural change. HMRC objective was to allow groups to structure their financing based on commercial drivers. HMRC was certainly aware that the proposals for dealing with forex did not eliminate all avoidance opportunities. Where, for example, a company looked to use a particular currency, not for any commercial reasons, but in order to get a tax advantage then this is something they saw should be countered through the impact of anti-avoidance legislation.

Alternative approaches

- 2.9 Although the proposals currently under discussion had the potential to address some of the issues which had been highlighted by HMRC, some non-HMRC participants expressed concern that such significant changes might also introduce problems of their own (such as the potential mismatches between tax and economic profits already discussed). The effectiveness and coherence of the proposals relied on all the situations in which exchange gains and losses should be tax effected being identified and specifically legislated for. From a practical perspective this could be challenging and there was a risk that there would be gaps, creating opportunities for avoidance and/or causing genuine commercial transactions to suffer anomalous treatment.
- 2.10 In light of this it was questioned whether there were any alternative, less dramatic, changes that could be made to address the issues seen by HMRC in practice. To answer this question first required a more detailed understanding of exactly what these issues were; a request was therefore made that HMRC provide, so far as they were able, some examples in which they felt the existing legislation gave the "wrong" answer. HMRC noted that water's edge investment companies were a typical source of problems and would consider if any further examples could be provided.
- 2.11 HMRC saw that there were still significant difficulties with the current regime. Ultimately there was a decision as to whether to work with the current type of approach and look to improve it, or alternatively whether it would be better to have a very different approach. HMRC had put forward a proposal as to how the rules could be structured. One of the working group members volunteered to summarise the benefits of the respective options.