

## **Minutes of WG1 meeting on 6 September 2013**

HMRC opened by confirming that the priority for this meeting was to progress the discussion on unallowable purposes. However, if possible, they would also like to get an initial view on “fairly represents” to understand where the key issues are likely to arise.

The group agreed the minutes of the last meeting and it was confirmed that these would be published on the HMRC website.

HMRC noted that the formal consultation was closed. They received approximately 50-60 responses, ranging from full spectrum responses to comments focussing on particular areas. While the Condoc response document is typically published at Autumn Statement, if the responses concern anything, which is relevant to the working group discussions, HMRC will raise the points in meetings as needed. They may also share certain passages if they are considered particularly helpful, subject to consent of the author.

The general impression from the responses is that most people support the overall aims, etc of the reform but some question the rationale / basis for the proposed changes in certain areas. There are also significantly different views emerging on some subjects, particularly in relation to “*fairly represents*”.

### **Unallowable purposes**

HMRC is adopting a twin track approach.

- 1) Discuss and finalise the specific changes proposed for FB14. HMRC noted that they are not trying to change the scope of objective of the rule but to clarify certain areas which have given rise to discussion or disagreement regarding the application of the rule.
- 2) Undertake more detailed discussion internally regarding the underlying principles and intended scope of the unallowable purposes rules. Clearly there are linkages with the first strand but they are separate.

It was noted that not all of the proposals are simply tweaks to the existing rule. HMRC agreed that this was not universally the case.

It was decided to use the discussion paper which had been prepared by the non-HMRC members of the group as an agenda for the meeting. HMRC noted that this should help to progress both strands but it was important to remember that the focus of the meeting was the Condoc proposals.

### ***Principles***

- The purpose test should continue to focus on the purpose of the individual company and not the purpose of the group or of the wider arrangements.
- The rule should continue to consider whether a tax advantage has been obtained by *any* person and it should not be possible to avoid the application of the rule by arguing that it is not possible to identify a specific company which has obtained an advantage.
- The relevant purpose should be the company’s purpose in being party to the loan or a related transaction and this should include transactions, which are, in substance, related transactions even if they fall outside the strict legal definition.
- The counteraction should continue to be on a just and reasonable basis, by which we mean that only debits which are attributable to the unallowable purpose should be disallowed.

HMRC agreed with all of the above principles.

- Whilst the definition of an unallowable purpose should continue to include activities which are not within the charge to corporation tax, this should not include borrowing associated with investments which give rise to income which, as a result of an exemption, is not subject to tax (e.g. exempt dividends, whether from UK or foreign companies).

HMRC agreed with this conceptually but noted that it is entirely dependent on the particular facts and circumstances. If it is a commercial borrowing, then there should be no issue. However, it is difficult to view this as a general principle as it depends on the circumstances.

- The target of the unallowable purposes rule is excessive debits (compared to the plain vanilla commercial transaction which does not have a tax avoidance main purpose). Much of the uncertainty that has arisen in the past has tended to derive from attempts to apply the rule to fix deficiencies elsewhere in the tax legislation. The provision should not be used to effectively tax a credit which for some reason falls to not be taxed (if it is appropriate to tax the credit, this should be achieved through other legislation, including other anti-avoidance provisions).

HMRC said that it depends on the circumstances of the debit. It was suggested by some group members that the unallowable purposes rule cannot be viewed as a "fix all". There have been situations in practice where it has not been possible for HMRC to attack a credit and they have tried to challenge a debit in an effort to get to the "right answer".

HMRC noted that it was difficult to say that there is a principle here and acknowledged that there will be cases where they do argue for this very outcome due to the particular facts. It is necessary to establish the purpose of the company in being party to the loan which may change over time.

The non-HMRC members of the group were of the view that this "principle" really just supports the point that the target of the rule is excessive debits. In practice, the likely outcome is that there are at least two main purposes and it becomes necessary to decide how much of the debit is attributable to each purpose. There was some discussion around the approach HMRC had generally taken in restricting debits that are bigger due to the avoidance. While there would always be debate about how this should apply in a particular case, the group generally thought that this approach worked well in practice.

The group queried whether it may be possible to adjust the wording around the "*just and reasonable*" test in the legislation. It might be possible to make some tweaks to the legislation / guidance to clarify how should apply. HMRC would welcome any further detailed suggestions around this.

- The rule should not generally be in point where a company is availing of a statutory relief, which was intended to apply in the particular circumstances (for example, the offsetting of non trade finance profits against brought forward non trade finance losses, or the partial exemption for certain finance company profits under the CFC regime). Obtaining a tax advantage should only be regarded as an unallowable purpose where the advantage is inappropriate or "unallowable", i.e. clearly inconsistent with the policy objectives of any particular relief.

HMRC found it difficult to agree with this, as a blanket statement. It is going too far to say that whatever a company might do to get within a statutory relief they should be entitled to a tax deduction for any debits created. There may be some circumstances where there is no issue but it is not necessarily true in all circumstances. There is a distinction between arrangements intended to fall within the scope of, for instance, a particular relieving regime and those which were not intended to but which someone has managed to engineer into the regime. It was noted that the TAARs in the relevant regime may be relevant here – if the arrangement is not caught by the TAAR then it may be difficult to understand why the unallowable purposes rule would be relevant. HMRC noted that there are discussions ongoing about this type of situation, particularly in the context of the new CFC regime, and the people leading those discussions were not at the meeting.

HMRC reiterated that the discussion at the meeting was focused on the specific FB14 proposals and the other strand was being considered separately. This was accepted but it was noted that there is material uncertainty, on both sides, regarding the application of the rule and, in light of the aims of the consultation to increase clarity and reduce the possibility for disagreement, it will be important to continue this wider discussion. It was also noted that it may be difficult to separate the two strands as some of the narrow FB14 proposals overlap with the wider discussions. HMRC agreed.

- The choice between debt and equity funding is a genuine commercial choice and the unallowable purpose provisions should not be applied to override this decision. There are already a number of provisions in the UK – thin capitalisation, anti-arbitrage and debt cap – which are designed to ensure that a deduction is only available in the UK for an appropriate and commercial level of debt.

HMRC noted that this one was difficult. In plain vanilla circumstances, they agreed with this principle. However, the fact that there is uncertainty is a by-product of the variety of different arrangements in practice. It is not possible to agree with the blanket statement. If a company needs capital for commercial purposes and chooses to borrow rather than issue shares, then the unallowable purposes rule is unlikely to be in point unless securing a tax deduction is a main purpose. If the choice depends on the availability of a tax deduction, then this is a dual purpose situation but there should be no debit attributable to an unallowable purpose unless there is a “main” purpose of obtaining a tax advantage.

It was argued that this is the wrong starting point. The availability of a tax deduction will almost always influence choice of debt and equity. The suggestion seems to be that this will immediately cause the rule to be in point and then bring the “just and reasonable” test into play. There is a view that the threshold is too low, i.e. “one of the main purposes”. Any company that borrows does so partly because of the tax relief. However, there is a difference between the consequence and the purpose of the borrowing.

The view was that it would be very useful to tease out where the threshold lies and HMRC was interested as to how this might be done in practice. It was suggested that there is a perception (not shared by HMRC) that there is a developing conventional wisdom that the threshold for a main unallowable purpose is very low and this is not helpful. In practice, the general approach is to leave the discussion on purpose and move straight to “just and reasonable”.

Everyone agreed that there is a distinction between consequence and purpose but everyone seemed to have experience in practice of consequence being argued as purpose. HMRC noted that there are cases where the “consequence” is the purpose of the borrowing and it is not possible to completely disregard consequences in determining purpose. This difficulty with this is that it suggests that strictly all loans have an unallowable purpose because part of borrowing decision inevitably has the tax consequence built in so ultimately it is necessary to rely on the “just and reasonable” test in all cases. HMRC agreed that it wasn’t a tenable position that all loans must have an unallowable purpose simply by virtue of the deduction as otherwise the test would be meaningless. They drew attention to the requirement for any unallowable purpose to be a “main” purpose for the rule to apply. However, it is difficult to clarify where the line falls and it is not possible to create a statutory rule which gives the answer without the need to interpret the specific facts of individual cases.

It was suggested that the other strand of the twin track approach may help to tease out which of the many anti-avoidance provisions is the appropriate one to apply. There is a benefit to clarifying the scope of individual TAARs. It was observed that HMRC should not worry about narrowing the scope of the unallowable purposes rule as there are many other anti-avoidance provisions available to target excessive deductions, e.g. thin capitalisation / transfer pricing rules ensure an appropriate level of debt versus equity.

HMRC accepted that they would have no problem considering how to make the unallowable purposes rule clearer and more targeted provided that they can get comfortable that there is no risk to HMRC. The unallowable purposes rule has been an effective tool so if they are going to make amendments they would need to be very clear on the reasons and consequences. HMRC would be happy to look at any suggestions for redefining / recasting terms if they provide more clarity and certainty.

- The effect of the provision, where it applies, should be to eliminate the tax advantage but not to create a “downside” or penal effect. If there is a desire to penalise avoidance activity, this should be achieved through penalties and not through creating tax charges where there is no economic profit or gain as this would create unacceptable uncertainty for taxpayers.

HMRC struggled to agree with this statement. If a company is party to a loan for an unallowable purpose then the debit is disallowed to the extent that it is attributable to the unallowable purpose. However, HMRC is proposing to go further with the proposal in relation to derivative contracts (fourth bullet of paragraph 14.32 in the condoc) as the change would allow for taxation of a profit where in fact there is an economic loss. If dealing with an uncommercial but not nefarious purpose then HMRC agreed it would be unfair to impose tax but if dealing with avoidance then less sympathy.

It was queried whether there was really any need to change the rule if the other proposals in the Condoc are adopted as it shouldn't be possible to engage in the avoidance activity.

Most people do not have any issue with a rule which prevents artificial debits even if it is acknowledged that such debits are unlikely to arise post-reform. However, in light of the ongoing debate as to where the line should fall, it was suggested that taxpayers should not be open to downside and that the proposal seems disproportionate given the expected amount of avoidance activity.

It was thought that it should be possible to achieve HMRC objectives without creating the level of uncertainty which would arise from the current proposal. However, in order to do this, HMRC would need to define more clearly where the concern lies and the legislation could then be more specific and less dependent of the interpretation of facts. The difficulty with this from HMRC's perspective is that there is no way of knowing what new schemes could be developed in the future to circumvent the new rule and therefore it needs to be broadly drafted. This was accepted but it was still thought that this could be achieved without creating downside, e.g. there may be something around denying the ability to net gains against previous losses where there is a related transaction (using the new definition) with an unallowable purpose.

HMRC asked the group to consider whether the bullet point included in the paper could be expanded to provide some suggestions as to how the legislation could be amended to achieve the stated objective in a manner which does not create the uncertainty which it is suggested could arise if the legislation was amended as put forward in the Condoc.

### ***Proposals***

- *Definition of "related transaction"*

It was agreed that this would be limited to the unallowable purposes rule. There is a separate wider question as to whether the expanded definition should be replicated throughout the legislation.

- *Netting of gains and losses on derivative contracts*

Per the previous discussion, HMRC asked the group to put forward proposed amendments to achieve the stated objective without doing more than eliminating the unallowable advantage.

- *Composite amounts*

It is still not clear why it is not possible to do this now under existing legislation. HMRC agrees that it is can be possible but they have encountered arguments in practice. The goal is to make it clear that they are not limited to looking at a single figure recognised in the P&L, when that amount reflects a number of components.

It was noted that it is difficult to understand exactly what the issue is here and therefore it is difficult to comment on whether or not there are any potential problems with the proposal. Some examples would be helpful to clarify what exactly is being targeted. The risk of amending the legislation to ensure that it does say what everyone understands it to say is that the amendments might actually change the law and possibly undermine the current position.

There is an overlap here with the 'looking behind the accounts' piece of the consultation and it may be difficult to make changes to the unallowable purposes rule without fully understanding the wider changes.

It was thought that it would be better to defer this discussion until the proposed legislative wording is available as this may assist in understanding the proposal.

- *Chance of securing a tax advantage*

No one had any issues with this proposal.

- *Group position*

It was agreed that the principle, as stated, is unobjectionable and the group believes that the law already allows for the group position to be taken into account. However, there is a clear link here to the wider discussion (the second strand) and there is a strong concern that, in the light of the less cautious approach currently being adopted by HMRC, the proposed change might allow HMRC to use the rule in a way which many would say was never intended. Again, it would be useful to get some examples to illustrate the concern here so the group can comment more fully.

- *Fungible pools*

The general principle is that a deduction should not be available for interest on funds which are used for unallowable purpose. This is accepted but the problem is how to determine whether the funds have been used for an unallowable purpose. Can you deem all of the pool to have been used for an unallowable purpose? What if there is a mix of debt and equity, how do you know it was the debt that funded the unallowable purpose?

HMRC is of the view that if there is a strategy of using a pool of funding to fund avoidance schemes but it is not possible to identify a particular loan relationship this shouldn't prevent the use of the unallowable purposes rule. This could not be accepted by everyone – the mischief here is the scheme and not the funding. If the debit would have existed irrespective of whether or not the avoidance scheme was implemented, the unallowable purposes rule should not be in point. It is also difficult to understand how such a rule could be drafted without requiring some form of tracing. There is likely to be material uncertainty. HMRC said that in principle debits arising from funding used in an avoidance scheme were a legitimate target of the unallowable purpose rules, whatever remedies may exist for the scheme itself; this principle was not changed by the fact that the funding came from a fungible pool. HMRC agreed that this may pose some evidential difficulties, but that is implicit in any purpose-based test. Again, it was decided that it would be necessary to see the proposed drafting before commenting further.

In any case, the general feeling among non-HMRC members of the group was that this one is out of step with other proposals. This seems to represent quite a fundamental change to the scope of the unallowable purpose rule and it is not a clarification.

HMRC noted that they are currently taking cases on this point but they would like in future to avoid the arguments over the need to link a particular loan relationship with the unallowable purpose. HMRC agreed that it may look like a new rule but conceptually this is just in line with policy. Many of the group was of the view that this is more fundamental and belongs in a broader debate with regime TAAR. There is a fear that this proposal could be much broader than intended. It was noted that HMRC needs to be very clear as to type of mischief being targeted. HMRC agreed to draft something for discussion.

Comment [RD1]: Are we?

- *New proposal – just and reasonable*

It was suggested by non-HMRC members of the group that the existing legislation could usefully be amended to clarify what the counteraction should be and, in particular, how the just and reasonable test will be applied, in a manner which is consistent with the approach which has been regularly agreed between HMRC and taxpayers (i.e. that the just and reasonable counteraction should disallow any debit over and above that which would have arisen absent the tax avoidance main purpose).

HMRC asked the group supply examples of how this might be worded to indicate more clearly how should operate. It was noted that making this less flexible may hurt taxpayers as well as help.

The usual approach in practice is to consider whether the unallowable purpose has caused the debit to be larger than it otherwise would have been. It might be worth including some guidance within legislation, e.g. “*in determining what is just and reasonable, the following factors may be taken into account...*” There is a question as to whether this would actually add any certainty or just give rise to an opportunity for further arguments and debates regarding the application of the rule. Again, there

is a link with the other strand in relation to what the rule is designed to achieve and the relationship with other regimes. Most are happy with the operation of the just and reasonable test in practice but there is a strong concern that cases end up here too soon. Most would prefer a clearer delineation of the application of the rule rather than relying on a just and reasonable consequence to ensure that the rule has no effect (where that is the appropriate outcome). Non-HMRC members of the group agreed to meet up before the next meeting and discuss possible wording.

## **ACTIONS**

- HMRC to look for examples to illustrate the concern around composite amounts and group position.
- Non-HMRC members to regroup to discuss proposals further and put forward some thoughts on wording in relation to derivative contracts and just and reasonable test.
- Group to start considering Chapter 3 and if possible make any suggestions prior to the next working group meeting.

The plan for the next meeting is to reach some conclusions on unallowable purposes and ideally start progressing the discussion on *"fairly represents"*. Draft legislation on unallowable purposes is unlikely to be available for next meeting but hopefully ready to share at meeting scheduled for end of October.