

Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 1 meeting on 10 October 2013
100 Parliament Street 10:00 to 12:00

1.1 **Unallowable Purpose (“UP”) rules** HMRC noted that in the representations that they have received on the six proposed changes to the unallowable purpose rules three of the changes were not seen as contentious (composite amounts, in substance related transactions and contingent tax advantages). As a result HMRC intend to draft the relevant amendments for inclusion in FB 2014.

The other areas were seen as more contentious and were discussed in more detail.

“Group” unallowable purpose situations

1.2 In response to a suggestion at a previous meeting, HMRC opened with a simplified example of a situation that could be covered by any change to the rules. The example involved creating intra-group debt between two companies, B and C, in order to fund B’s acquisition of an interest bearing receivable from another group company, A. The suggested purpose of the arrangement from HMRC is that B’s acquisition of the receivable is purely to enable losses created in a fourth group company, D, to be utilised via group relief to shelter the receivable in B. The concern from HMRC’s perspective was that as a result of the arrangements the group’s overall UK CT liability was reduced and it was potentially difficult to identify a specific company that had a tax advantage. Company A doesn’t have a tax advantage by not being taxed on income it no longer receives. Company D has created losses but doesn’t itself have a relief from tax. And it is argued that company B doesn’t have a tax advantage because it didn’t pay tax before the transaction and doesn’t pay tax after the transaction. HMRC said they do have challenges to the arrangement but could the definition of tax advantage be changed to make it work better in this type of scenario?

1.3 However given the facts of the example the concern seemed to be focussed on transactions which allow companies to access losses, which has been discussed at previous meetings and where it has been agreed HMRC would consider further to determine whether there is a policy concern here. It would still be useful to have some other specific examples from HMRC for the group to fully understand HMRC’s other concerns.

1.4 HMRC confirmed that they are still aiming to include legislation in Finance Bill 2014 to deal with “group purpose” based arguments but they acknowledged the need to reflect on the concerns raised and will feed back to the group before any announcements in the Autumn Statement.

Fungible pooling arrangements

1.5 This issue was discussed. HMRC agreed that this was a difficult area and so have decided to allow for more time to consider how best to proceed. As a result, measures will be included in Finance Bill 2015.

Netting losses against gains on derivative contracts – s692 CTA 2009

1.6 HMRC acknowledged the difficulties that would arise from the proposed changes to eliminate the netting rules in s692 CTA 2009. An alternative proposal was made for a more limited withdrawal of the netting rules where the transaction that gave rise to the loss had an avoidance purpose. This would counter planning arrangements such as those that have sought to shelter gains on in the money derivative contracts. These changes would be included in FB 2015.

2. Chapter 3 – the proposed framework

2.1 Two issues have been noted with the proposed changes to the framework for the taxation of loan relationships/derivative contracts:

- i) The timing for introducing changes; and
- ii) The uncertainty for the taxpayer which would be created by the proposed framework,

Timing for the introduction of proposed changes

2.2 It has been suggested in representations that there might be difficulties for taxpayers managing the process of converting to new GAAP at the same time as getting to terms with some newly introduced tax legislation. HMRC has received representations that companies would rather transition to new GAAP under the existing loan relationship and derivative contract rules to simplify the transition.

2.3 There is a question of what changes should be made effective for accounting periods beginning before 1 January 2015. HMRC have confirmed that they intend to limit the scope of changes to the tax rules prior to the mandatory GAAP transition deadline. Changes will focus on the following three areas:

- i.) Updating the Disregard Regulations and the Change of Accounting Practice Regulations for the CTA statutory references;
- ii.) Updating the elections under regulation 6 of the Disregard Regulations; and
- iii.) Dealing with exchange movements on certain debt currently accounted for as permanent as equity.

2.4 HMRC confirmed that they propose introducing changes to the above areas through secondary legislation in the first half of 2014. HMRC propose that the main changes being proposed would be expected to come into effect at a later date in order to ease the burden on companies in the year of GAAP transition. The working assumption (to be determined) is that the changes would be included in Finance Bill 2015, to be effective for accounting periods beginning on or after 1 January 2016.

2.5 As part of the changes being proposed to be effective from 2016, HMRC are seeking to simplify the Disregard Regulations through repealing many of the regulations and rely more on hedge accounting. A concern was raised in WG3 that these changes could impact on current decisions on hedge designation for accounting purposes. On this point HMRC has indicated that the treatment for any existing derivatives is likely to be grand-fathered.

2.6 There were no objections expressed to these proposals.

“Fairly represents”

2.7 HMRC wanted to understand the reason for the representations they had received regarding the creation of significant uncertainty through proposed changes to the fairly represents rules. HMRC reiterated that they consider that the existing rule allows accounting results to be challenged where the debits or credits produced are not a fair representation of the loss or gain arising to a company. Such a rule was necessary given that the regime taxes loan relationships or derivative contracts which are legal constructs but seeks using accounting framework to measure

the relevant profits and losses. Given that the scope of the accounting framework, and the fact that it does not operate by reference to the same legal constructs, some areas of disconnect were inevitable and had been used in avoidance transactions in the past (e.g. those using derecognition). They also noted that this issue was currently being litigated.

- 2.8 There was not agreement that the fairly represents rules currently allows GAAP compliant accounts to be overridden. Given this, there was concern that the proposed changes, which from HMRC's perspective aimed to clarify and make more implicit this statutory override, would introduce substantial uncertainty and subjectivity at an early stage in the computational process. The key concern focused on how to determine what the alternative fair result should be. As a result there was general consensus amongst the advisers that statute should be as prescriptive as possible.
- 2.9 It was stated by HMRC that they were aiming to achieve the "right" answer for tax purposes. HMRC also noted that the approach adopted in s46 CTA 2009 in respect of a company's trading profits i.e. tax follows the accounts unless there is a specific exception. It was not universally agreed that this allows GAAP compliant accounts to be overridden.
- 2.10 HMRC considered that whilst the "fairly represents" override was needed to deal with avoidance, advisers have also used the "fairly represents" rule to argue that credits are not taxable. So narrowing the rule could adversely affect commercial transactions in the future. It was thought that many of these issues would be dealt with by only taxing credits and debits in the Income Statement. However HMRC agreed to provide more details on those commercial situations where these arguments have been raised in the past. An example given was single member co-op structures but more details/examples would be helpful.
- 2.11A particular concern expressed was the potential for inconsistent application any "fairly represents" override provision by HMRC local offices, especially with increasing complexity of GAAP.
- 2.12 A strong preference was expressed for no "fairly represents" override rule. Instead the taxable amounts should generally be based on the accounting results, subject to specific statutory provisions where the accounting results will be overridden. HMRC emphasised that such an arrangement was a two way street, providing greater certainty for taxpayers but also potentially resulting in an unfair tax result without scope in the rules for the taxpayer to use "fairly represents" to produce a fairer result.
- 2.13 HMRC agreed to consider this further and come back to the group on their conclusions and with further specific examples where "fairly represents" is currently used to correct disconnects between the accounting and tax outcomes.