

Minutes of WG1 meeting on 19 December 2013

Opening comments

The group confirmed there were no comments on the minutes of the last meeting or on the Response Document which was published on 10 December.

HMRC noted that the focus is now moving to Finance Bill 2015 and they are starting to think about the best approach to ensure all issues are covered and instructions are sent to Parliamentary Counsel in time to get legislation produced.

Strawman of new legislation

HMRC explained that they had prepared a spreadsheet setting out an indicative outline of the new legislation. The purpose is to test / explore the implications of any proposals. The strawman was first prepared before the Condoc was published in order to help define the initial proposals.

The group walked through the legislation and pulled out certain areas for discussion.

- *Part A – Introduction*

This part would be similar to the existing introduction but somewhat longer. It would contain more of an explanation of certain key concepts.

One goal of the consultation is to develop robust and coherent legislation, which is designed to deal with future events. Avoidance should be difficult and indeed may not work at all so there should be no need for some of the specific TAARs to deal with individual issues. The legislation needs to be linked together in such that a way that if things change, e.g. new instruments are developed or new policies introduced, it should be easy to update legislation to reflect the changes. The existing Parts 5-7 include many small changes to deal with specific issues and the structure is no longer as clear as it originally was.

There are four key elements:

- 1) Subject matter of tax;
- 2) How brought into account (income v capital, etc);
- 3) Measurement; and
- 4) Timing.

The existing legislation is very compressed as s307 deals with a lot of these issues together. The proposal is to break this up and provide more detail.

- *Part B – Scope of regime and how matters are taxed*

The matters are essentially the same as in the current legislation but they are clearer and the definitions are not mixed in with accounting. There is more detail in later provisions around meaning of a loan relationship, derivative contract, related transaction, etc.

- *Parts C-D – Measurement*

This part will refer to the amounts stated in the accounts (in accordance with GAAP), which are related to the "matters" specified in Part B. This is fundamentally the profit or loss but there will be some special circumstances.

There is a need here to bring out /test some of the ideas emerging from the consultation, e.g. looking behind the accounts. There is also the single loan relationship versus basket issue discussed at last meeting. Think should be both. Normal = portfolio subject to specific rules re individual LRs. Would it help to be explicit in legislation - clearer if not shorter / simpler.

- *Parts G-K – Modification to fundamental framework*

The strawman includes a table, which is similar to the one set out in the Condoc listing the types of scenarios where modifications to the general rule are required. The table is slightly different from the previous version. It notes the nature of the modification, e.g. no amount brought into account (such as distributions which are subject to a different regime) or avoidance (same regime but non-deductible). Part J deals with interference or looking behind the accounts.

- *Parts L-N*

These Parts set out detailed computational rules for the different scenarios. Specific rules are required to bring certain amounts into account. Some of this is also about working out loose ends where something is needed, e.g. foreign exchange. Part N deals with hedge accounting – this might form part of the regime or be dealt with separately in the Disregard Regs.

- *Part O onwards*

Everything is the same as under the existing regime other than the regime TAAR. With regard to the regime TAAR, there is a general principle and then specific situations with potential counteractions.

Commentary on the strawman

HMRC noted that an overarching view of what is happening across the consultation is required and this role is likely to devolve in part to WG1. This document is intended to be helpful in providing sight of the overall picture.

It was acknowledged that transition has not been considered in detail yet, and different rules will probably be needed for different cases. The starting point is to identify which parts represent significant change from existing legislation. There is quite a lot with no substantive changes. There is a need to identify new sections / areas where the legislation is doing something different in order to get a picture of what is needed in terms of getting new legislation drafted and working out transitional rules.

The key transitional items will include a) items initially recognised in OCI; and b) foreign exchange. Much of this will therefore fall within the remit of WG3. With regard to the general framework there may not be any fundamental substantive changes but rather certain areas where the approach could be clearer or some difficult points could be dealt with in a better way so there may not be a need for significant transitional adjustments.

There is a spectrum of changes from areas where there may be a completely new policy direction to matters where there is no intention to achieve a different result but a desire to present the legislation in a way which should make things easier in future. For example, s307 covers a lot of different issues as it currently stands and there could be significant benefit in separating out the functions so it becomes clearer what the core of the legislation is doing. This doesn't necessarily mean a different result and so it

doesn't necessarily mean that any transitional rules would be required. The first step is to identify what is new but then further work will be required to determine the extent / nature of any changes.

The group queried the extent to which the purpose of the strawman is just to smoke out issues and the extent to which this might actually illustrate how the legislation will look under new regime? Some of the sections listed seem to go to the fundamental principles discussed at last meeting. HMRC reiterated that the strawman is not to suggest that these issues have been decided and the points are still very much up for discussion.

As no one in the group suggested otherwise, HMRC noted that they are going to work on the basis that the strawman has a useful purpose and they will continue to use this in constructing a plan / approach for next year. The group wondered whether the sections in the strawman would eventually be backed up by legislation. HMRC emphasised that it is the role of Parliamentary Counsel ("OPC") to draft the legislation based on instructions from HMRC on the policy. Once HMRC provides a specific set of instructions, OPC will either come back with questions or produce draft legislation which will typically raise a number of additional issues for discussion. It is an iterative process and the various iterations will feed back to working groups as appropriate. HMRC may give a version of the strawman to OPC as a guide but it may not read across directly to the legislation as OPC will draft the legislation as they think appropriate.

The group noted that to the extent possible, it would be helpful to minimise the discontinuity of the strawman with the eventual legislation. HMRC agreed that they would want to map the strawman onto the legislation. The legislation will be produced in pieces so it should be possible to map the sections onto the spreadsheet and / or update the spreadsheet to match drafting. The intention is that the strawman will form a control to monitor the progress of the consultation – actions completed and outstanding, etc.

One of the purposes of the strawman is to test out how the provisions might fit together but it is not designed to be the legislation. The goal is to identify which elements are missing, which provisions are potentially in the wrong place, how they fit together, what is not giving the right answer, what could be simplified, etc?

The group queried whether the other working groups will see the strawman as well. HMRC confirmed that all groups will feed in but the other groups are generally looking at more discrete pieces of legislation rather than the framework. The group in general thought it would be helpful for the other groups to feed into the strawman. HMRC agreed that it would be shared with the other groups but they wanted to go through it with WG1 first. It was noted that there may be potential for some disconnect between the groups, e.g. it is possible that WG2 will want a rule to deal with situations where accounting gives the wrong result but this may conflict with views taken in WG1 about the desirability of a general override.

With regard to the overall coherence of new regime, Andy Stewardson has been invited to take up an offer from the Legislation Sub-Group of the Business Tax Forum (a group comprising representatives from industry and HMRC who have an interest in tax legislation generally). The group has a general concern that new legislation is not always coherent and it has been suggested that the loan relationship consultation could be taken as a test case. The idea is that the regime would benefit from input from people who are not closely involved in the design / drafting with a view to considering the shape of the legislation and how it fits together. This would not be about revisiting policy or the various discussions in the working groups but rather ensuring that the end result clearly articulates the stated policy.

The group wondered whether OPC would be part of this group. HMRC agreed that it could be helpful but noted that historically the relationship between HMRC and OPC has been more formal (e.g. client to service provider) and it may not work to bring the drafters closer to policy formulation. OPC have a remit of drafting legislation and they are under a lot of pressure. The HMRC team is due to meet with OPC in January to start mapping out a plan for Finance Bill 2015 and they will discuss this possibility with them and also what kind of approach they want to take more generally.

It was noted that the Law Society had a meeting regarding the development of new legislation and it was agreed that early publication of a framework so people have time to comment on the shape of legislation is

important. Once the legislation has been drafted in full, it is almost impossible to restructure and the views of users of the legislation don't adequately get taken into account. The spreadsheet is exactly what the Law Society wanted to see in advance of the legislation being drafted.

HMRC confirmed that the spreadsheet was not intended for general consumption at this stage. It is a tool for discussion and, given that a lot of proposals have not been fully developed yet, it may spark unnecessary concern if shared with a wider audience at this stage. The group appreciated this but reiterated that it will be important to ensure that users of the legislation are given an opportunity to feed into the process. There is a balance to be struck between giving users a general idea of the direction of travel and provoking unnecessary concern.

HMRC noted that they are working on the basis that something will need to be published during the year in order to provide a general update on progress. The obvious time would be around Budget and the hope is they will have a reasonable idea of plans by this time. In addition to managing expectations, HMRC agreed that it is a good idea that people know what is coming. HMRC will consider what should be published – it may be more of a progress report than a full framework. It is possible that another (shorter) consultation document will be required to seek input on any outstanding issues where there is some debate. However, this has yet to be decided. It was noted that there will probably be a need to produce a skeleton version of the framework for the purposes of sharing with OPC and this may be suitable for wider publication.

Looking behind the accounts

HMRC noted that the reaction at the last meeting to the paper prepared by HMRC was somewhat “lukewarm”. The paper sought to develop a proposition out of the initial proposals and looked to deal with a couple of obvious difficulties with the proposals in the Condoc, e.g. the reference to economic profits and life of arrangement, etc. The suggested solution was to be more specific about the approach to be adopted if such a rule was triggered, i.e. look at the accounting that would have applied if the accounting had not been influenced by other transactions or instruments.

HMRC summarised the issues / potential difficulties with the proposed approach which were raised at the last meeting.

- The need for hypothetical accounting;
- The potential need to track LRDC matters separately in order to determine whether the rule is triggered;
- Profits are a commercial concept and this is reflected in the accounts so why can't we just tax the amount per accounts?
- Trade profits are determined based on the accounts without any need for complicated rules so why are they needed here?
- In so far as the rule would operate as a potential safeguard for HMRC, if the regime TAAR is enacted then this would be covered here anyway.
- Where items in the accounts encompass LRDC amounts and non-LRDC amounts, there is a need to consider how the non-LRDC amounts should be taxed.

One of the issues raised at the last meeting on which HMRC didn't comment was whether the regime does / should operate on the loan relationships of the company, taken as a basket, or whether it should look at each loan relationship separately. The spreadsheet reflects HMRC's view on this – the basic function of the legislation is to tax the portfolio of loan relationships but, where specific rules are / may be relevant, the obvious implication is that it will be necessary to look at individual loan relationships to determine if, when and how the specific rules apply. HMRC noted that this shouldn't be any different from the current position and so it is not clear why this rule seems to be giving rise to specific difficulties in this regard.

It was suggested that one of the issues is that taxpayers will not want this rule applying all the time, e.g. in simple cases where there are two loan relationships and the legislation requires them to be split out and taxed separately even though it gives the same result as taxing them together. If this rule is going to be

included in the new regime, it needs to be narrowly focused and only applicable when necessary rather than included as a broad principle. If this rule requires all relevant instruments to be tested to determine whether the accounting would be different, it will become unworkable. The focus should be on how to make it sufficiently narrowly targeted so that it only applies when strictly necessary, e.g. the term “gateway” was used. However, it is not clear how this would work in practice.

There are two views as to how this rule could be applied - top down and bottom up. The view in the condoc and the HMRC paper is top down, as it looks in theoretical terms at how the regime should be structured to achieve its aims and then at what rules are needed to ensure this works, i.e. tax all correct matters. Following that approach, the HMRC process is to identify those areas where special rules are needed anyway and then specific areas where it is not possible to determine exactly what the result should be, given that it is not possible to predict all eventualities. HMRC has been assuming that there will be a need for a rule which is capable of being sufficiently flexibly expressed to cover any eventuality. The view from many in the group was that this is not required. It might be theoretically desirable but in practice the preference would be to identify specific areas of difficulty and deal with those and not worry too much about putative cases that cannot be identified. This is on the basis that either it should be possible to identify all cases that will need special rules or it will at least be possible to get sufficiently close to identifying all cases such that the complexity and uncertainty that would derive from a less precise rule will outweigh any potential benefits.

The group needed to take a view on where the balance should lie between a) the desire to be clear on the scope of application of the regime and get the “right” answer in light of the purpose of regime; and b) the potential complexity of a “looking behind accounts” rule and the potential for uncertainty. There is then the overlay of the degree to which this plays into protection against avoidance (although the genesis of this rule is not anti-avoidance, but the desire to ensure that the regime is comprehensive). It was suggested that the avoidance angle can be covered by regime TAAR so the question is then to what extent the rule is serving an anti-avoidance function and to what extent it is providing an opportunity to get to the right answer in each case. The HMRC paper identifies a number of scenarios where the conclusion is that there would be no need to apply the rule. Thus, if the rule was introduced, a number of specific exclusions would be required. In light of this, it may be simpler to omit the general rule and instead deal with the specific scenarios where the conclusion is that the rule would be needed.

HMRC acknowledged this logic but the difficulty is the “unknown unknowns”. There are always likely to be some circumstances which haven't been considered. If these cases relate to avoidance, then they can perhaps be dealt with using the regime TAAR but there is no cover if there is no avoidance, or the result is to the detriment of the taxpayer. Also, if there is no general rule, changes to accounting for example may require new specific rules.

A concern was raised that the views of WG1 may be different to WG3 which is looking at some issues arising with respect to accounting changes. WG3 may conclude in favour of a general rule to deal with accounting issues while the view of many in WG1 seems to be that the perceived uncertainty arising from a general rule would be worse than specific rules which may have to be amended to deal with new issues. This is on the basis that the uncertainty is worse than the potential downside, acknowledging that the real difficulty is often for the first person who encounters the issue.

It was suggested that this is similar to the debate in relation to Chapter 3 (“fairly represents”) though it is more narrowly focused. HMRC was of the view that there is a difference in that there was no specific alternative in Chapter 3 if the accounts were set aside, while the “looking behind the accounts” proposal does propose an alternative measure, i.e. what the accounting treatment would have been absent the “interference”.

The process for introducing future changes to the legislation was discussed. The possibility of granting HMRC regulation making powers was discussed but it was noted that it would be difficult to justify broad powers which would permit amendment of primary legislation. As a general point, where a “fix” relates to avoidance activity, it is generally likely to be easier to obtain Finance Bill space than where there is an issue with the legislation is not causing any loss to the Exchequer. Therefore, there is a need to be

cautious about relying on HMRC's ability to effect quick changes to the legislation to resolve any issues (particularly in view of the significant resource already being put into the FB15 changes).

There are already extensive powers in the loan and derivative regime for making changes to the statute where there are changes in the accounting treatment, including the power to amend primary legislation. However, this latter power is subject to affirmative procedures. These help with addressing significant, widespread issues outside of the finance bill process. This does not help address 'one-offs'.

If there are clearly defined principles about situations where changes may be required in the future, in particular the circumstances where it is appropriate to depart from the accounting treatment, then it may be easier. This is the thinking behind setting out categories of departures from the accounts in the legislation as it makes it easier to slot in new rules to deal with specific scenarios and hopefully structural integrity is maintained.

A particular concern was expressed with the taxation of debt restructuring and the length of time it has taken to "fix" the issues arising as a consequence of IFRS accounting. It was suggested that the solution would not be a general "looking behind the accounts" rule in any event as the issue concerns the recognition of credits from amending the terms of the debt (and hence does not reflect any interference from other matters). There is a separate question of how to deal with "interference" and this is potentially a "looking behind the accounts" rule.

As noted above, there is concern that a general rule may create more issues than it solves. With regard to the paper, only a few of the scenarios identified actually require adjustment and so, it was suggested, it should be possible to deal with these under specific rules. HMRC noted that they cannot give away the ability to tackle avoidance. Everyone accepted this but, in general, the feeling was that it should be possible to manage this using the regime TAAR rather than a general rule that allows accounts to be overridden. It was noted that this will leave a gap as there is some downside for HMRC which is not related to avoidance.

It was suggested that a "looking behind the accounts" rule, were it introduced, might be subject to a gateway-type test where the rule only applies in listed, narrow circumstances. It was agreed it might be possible to explore this, but it was not clear what the gateway conditions might be.

The group asked whether HMRC was aware of any specific circumstances which are known but where it is not possible to draft a specific rule or whether the concern was solely about unknown possibilities. It seems that it is the latter. In this case, it was suggested that the group's preference would be to cover all known issues and accept the possibility that some amendments may be required at a later date, with the risks which that would entail.

HMRC asked whether the general preference was for a bottom up approach, based on identifying and addressing instances in which tax treatment would depart from accounting profit and loss, as opposed to a top down approach which would seek to define the role of accounting in a principled way that could be applied with less need for detailed rules. Some group members suggested a general principles-based "looking behind the accounts" mechanism and then a list of circumstances in which the rule should apply. There could be both a general principle to explain the overall approach and then specific rules to apply the principle to specific and limited scenarios. HMRC suggested that this would eliminate both the possibility to deal with cases which haven't been thought of and also the ability to specify a particular outcome in particular cases and so could be the worst of both worlds. In addition, it was not clear, under such an approach, what value would be added by linking the specific rules to any broader "looking behind the accounts" principle.

Other

HMRC noted that they had planned to discuss the combining of the loan relationship and derivative contract regimes but there was insufficient time so this would be picked up at the next meeting. The strawman currently assumes that the regimes will be combined but this is open for discussion.