**Modernising the taxation of corporate debt and derivative contracts**

**Minutes of Working Group 3 meeting on 30 July 2013**

**100 Parliament Street 11:30 to 13:00**

**Attendees:**

Andrei Belinski, Centrica

Neil Edwards, PwC

David Hill, Grant Thornton

Matthew Hodkin, Norton Rose

Kashif Javed, KPMG

Chris Kell, HSBC

Jackie Latham, Rolls-Royce

John Lindsay, Linklaters / CIOT

Anne Murphy, Legal & General / ABI

Kieran Sweeney, LBG

Fiona Thomson, Ernst & Young

Stephen Weston, Deloitte

Charles Yorke, Allen & Overy

Richard Daniel, HMRC

Andy Stewardson, HMRC

Andrew Gribble, HMRC

Chris Murricane, HMRC

Roger Muray, HMRC

Roger Bath, HMRC

Jamie Bedford, HMRC

**Opening statements**

HMRC opened the meeting by setting out some guidelines for the working group. The key points were as follows.

1. The meetings will be minuted to capture the main points raised. The minutes will be sent to the group leader in the first instance and he will then circulate the minutes to the group for review and comment. Once agreed, the minutes will be sent to the other working group members as there is a lot of cross-over between the groups and this should help to ensure consistency. HMRC emphasised that they want the process to be open and consultative.
2. It is important to note that the purpose of the groups is to discuss and consult but they cannot make decisions. Ultimately HMRC will make recommendations to Ministers. The intention is for the groups to consider all of the feasible options and ideally arrive at shared understanding as to the best option in the various areas. The goal is to find a solution which commands maximum consensus though HMRC acknowledged that universal agreement is likely to be quite difficult, especially in certain areas.
3. It was expected that the whole group would look at all of the issues covered by this part of the consultation document. It may be the case that a small group will meet to look at specific points, but with the intention that they will then feedback to the others at the main working group meetings. HMRC was also keen for the group to be a forum for members to raise issues arising from the anticipated accounting changes – for example, with the transition to FRS 101 / FRS 102 / IFRS 9.
4. HMRC noted that the consultation comprises three broad strands of activity. First, there is the consultation document itself in response to which HMRC is expecting to receive written representations from various parties. Second, the four working groups have been established to discuss the proposals in more detail. It is intended that these groups will continue to meet regularly throughout the process until the FB 2015 legislation is finalised. Finally, HMRC is holding bilateral meetings with interested groups / organisations. The intention is to generate lots of discussion and ideas. All of the strands will feed into each other.

**Hedge Accounting / Disregard Regulations / Forex**

1. The view is that the proposed changes are based on the assumption that hedge accounting will be more widely available under FRS 101 / FRS 102 and IFRS9. It was also noted that the proposals depended on the introduction of changes in IFRS9. However, it is likely to be a few more years before a final IFRS9 is endorsed by the EU.

*Undesignated hedges*

1. There were some concerns raised in relation to the proposed withdrawal of the Disregard Regulations, particularly in the context of undesignated hedges.
2. A point was made that there are still likely to be commercial situations where hedge accounting is not going to be available for some businesses and this undesignated hedge will lead to considerable tax volatility which would not be welcomed in most cases. Macro hedging and dynamic portfolio hedging were cited a two possible situations. Specific examples are going to be provided to HMRC.
3. Some concerns were also raised in relation to companies which will be required to adopted FRS101 and FRS 102 – they might not be fully aware of the requirements to designate hedges under the new regime, and might not fully appreciate the implications prior to the deadline. It was noted that the deadline is 1 January 2014 for companies who will adopt FRS 101 or FRS 102 for the year starting on 1 January 2015.
4. In relation to the transition between the existing tax rules and the proposed new rules, some companies might rely on the Disregards Regulations on transition to FRS 101 and FRS 102 only for the provisions of the Disregard Regulations to be taken away shortly afterwards.
5. A further comment was raised in respect of the volatility associated with the undesignated hedge problem in the new regime. On interest rate and FX contracts the volatility is often going to be in one direction in any period which could have a material effect of increasing short-term volatility on the Exchequer.
6. A further point was raised that as far as groups of companies are concerned, it is the consolidated accounts which matter and hedges are designated at that level. To have to designate hedges at all subsidiary levels to achieve a tax accruals basis can be quite burdensome when the Disregard Regulations already achieve this on a company by company basis.
7. It was suggested that the Disregard Regulation were effective in maintaining an accruals basis for tax purposes and that, if it is accepted that not everyone can hedge account for derivatives it was questionable whether fully repealing the Regulations at this time was the right approach.

*Time limits*

1. It was noted that the typically two camps – those who wanted to follow the accounting position with minimal computation adjustments and those who wanted to rely on the tax rules to remove accounting volatility.
2. A particular problem experienced in practice was the current time limits for making elections under the Disregard Regulations. It was suggested by the Group that the current deadline for submitting an election in respect of the Disregard Regulations could be extended so that companies fully understand the implications. This would be preferable from the industry perspective. HMRC noted that generous time limits had been exploited in the past to give companies the most favourable result. A suggestion was made that the making of an election could apply prospectively. The current approach of only having one opportunity to make any election was thought to be overly restrictive.

*Complexity*

1. HMRC noted that the Disregard Regulations were often cited as an area of complexity in the regime. It was not easy for companies that had transitioned to IFRS to apply and the same issues would be facing companies moving across to similar issues under FRS 101 or FRS 102. HMRC also noted that the Regulations referred to the original legislation in FA 1996 and FA 2002.
2. The general view expressed was that the complexity of the Disregard Regulations was justified when it is considered alongside the accounting changes being suggested, but some discussion was had around whether the rules could be considerably simplified to achieve the same effect.
3. HMRC noted that part of the difficulty with the Disregard Regulations is that they have to deal with designated hedges that are ineffective for tax as well as undesignated hedges. There was general agreement that it would helpful if tax issues relating to designated hedges were dealt with in the primary legislation. The Group was generally content with the proposals around following the income statement for designated cashflow hedges and facilitating designated fair value hedges of connected party debt. It was noted that allowing fair value adjustments to be made to connected party debt would make things simpler for hedge accounting but could also mean additional complexity elsewhere, notably with debt releases.
4. Some discussion was had as to whether HMRC could have a simpler, principles-based, equivalent to the Disregard Regulations, that provides an accruals basis for economic hedges, whether designated or not, whereby the tax treatment of the hedge follows the tax treatment of the underlying item. The view was expressed that such an approach would pick up interest rate swaps, currency contracts and forex contracts and in any case 99% of the time the underlying item is income based.
5. HMRC noted that they certainly saw that this was a principle underlying the proposals on forex hedges. They did see there was a conceptual difference between forex and non-forex risks. It was typically the case that you would want to tax non-forex movements as income and so it is normally a timing issue. This is the approach which the Regulations currently take.
6. HMRC noted the discussion about the Disregard Regulations and commented that if the Regulations are doing something useful and succeeding in this, then from a policy perspective, this has to be taken into account.

*Forex*

1. Some discussion was had around the proposal to only tax and relieve forex movements that arise from a trade or property business. The Group also discussed whether it would be appropriate to remove all forex movements from tax.
2. HMRC noted that this is an area where they had continued over the years to see significant risks – both avoidance and also seemingly fortuitous outcomes. HMRC also continued to receive representations from business and advisers that the disregard regulations should be expanded to exclude further categories of forex amounts from tax.
3. The view was that many businesses look to minimise forex risk. The proposals would make this easier and should generally give an appropriate result.
4. However, even with the best intentions groups can be exposed to forex risk. For example, where there is a delay in changing net investment hedges for changes in the underlying investment values then this volatility would feed through into the consolidated accounts. If the tax treatment did not match the accounts treatment, this could have a significant impact on the group’s effective tax rate which would generally not be the desired outcome.
5. It was thought that the proposal to only tax or relieve forex amounts arising from a trade adds considerable tension to the distinction between trading and non-trading activities. This approach could also give rise to some asymmetries between companies within the same group, although that can already be the case under the current rules. Such an approach would work well for permanent-as-equity loans which are treated as part of the net investment on consolidations. However, it may not work so well with other non-trading balances and cash pooling arrangements as they are not always economically hedged.
6. A further area of potential difficulty highlighted by the Group was the question of whether group treasury companies would be regarded as trading or not. It was felt that HMRC could give some guidance on this in the new rules. Again it was noted that this could create asymmetries one way or the other. Potentially there may be scope for group treasury companies to elect out of the non-trading treatment.

**Timing of any changes**

1. Some concerns were expressed about the interaction between the proposed commencement dates for the new rules and the introduction of IFRS 9 which was now likely to be 2016 or 2017. With the new rules predicated on the principles of IFRS 9 this could create some difficulties for companies which have to apply IFRS rather than FRS 101 and FRS 102 which are to come into force within the time that the new legislation is introduced.
2. Some questions were raised whether given this there could be a two-stage approach to introducing the legislation to accommodate these accountancy timing differences.
3. There was some discussion around the timing of the legislation. With most of the changes expected to be in FB15 it is unlikely that these elements would be introduced in time for companies which need to apply FRS 101 and FRS 102 for the first time in 2015. There was a concern raised about companies having to go through two separate changes in a very short space of time. The view was put forward that HMRC already have a regime which is largely working and capable of dealing with the transition to FRS 101 and FRS 102. Is there merit in changing this ahead of the main transition to FRS 101 and FRS 102?
4. HMRC noted that they did have extensive powers to amend the statute through secondary legislation for changes in accounting which could be used to introduce amendments ahead of 2015. However, HMRC considered it important to have a clear view as to the end result for the tax rules. HMRC was also though conscious that the current rules are not easy to apply, and if there are specific aspects that can easily be improved ahead of the main transition to FRS 102 then these could be considered.

**Follow the Profit and Loss**

1. There was a general consensus was that a regime that starts from the P&L is a good thing. A couple of comments were made in respect of ensuring tax recycling for certain items that may never make their way to the profit and loss.
2. A point was also made about the interaction between the treatment of regulatory capital and related instruments. There was a risk that companies could end up with a difference in tax treatment.

**Hybrids**

1. HMRC acknowledged that there is a lot of complexity here in the current statute book and with the accounting rules likely to change how these instruments are reflected in the accounts it had to also be considered from a tax perspective. No substantive comments from the Group in respect of the proposed changes. General comment that not many convertible loan assets are held by UK corporates – these are often held by tax exempt entities. The existing rules for issuers are still needed and some feeling that it would be good to keep the current treatment, as this is something business is already familiar with.
2. HMRC noted that they had continued to see companies seeking to benefit from holding Index Linked Gilts (ILGs) in ways unintended by the statute. In respect of ILGs, the Group noted that these were not widely used from a commercial perspective outside of financial services and insurance. A question was raised as to the policy behind the relief. It was noted that by setting up such a tax favoured relief, HMRC should have expected these instruments to be subject to tax planning arrangements.

**Next Steps**

* HMRC will circulate notes of the meeting to the Group.
* HMRC will send out meeting requests for the other proposed dates in autumn / winter 2013. HMRC will also look to fix dates for 2014.
* Before the next meeting on 10 September HMRC will circulate a proposed road map to the Group, to bring out some of the timing issues with the anticipated accounting changes on the horizon.