Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 3 meeting on 8 November 2013
1 Horse Guards 10.00 to 12:00

Attendees:

Andrei Belinski, Centrica

David Boneham, Deloitte

Paul Freeman, KPMG

David Hill, Grant Thornton

Matthew Hodkin, Norton Rose

Chris Kell, HSBC

John Lindsay, Linklaters / CIOT

Anne Murphy, Legal & General / ABI

Chris Murphy, KPMG

Kieran Sweeney, LBG

Fiona Thomson, Ernst & Young

Stephen Weston, Deloitte

Charles Yorke, Allen & Overy

Jackie Latham, Rolls Royce

Graham Williams, PwC

Richard Daniel, HMRC

Rob Harvey, HMRC

Roger Muray, HMRC

Andy Stewardson, HMRC

1 Administration and points from earlier meetings

Working group minutes

1.1 The draft minutes of the WG3 meeting on 4 October had been circulated and no points had been raised; if any participants wished to make comments prior to the minutes being published then these should be directed to Richard Daniel.

Response to consultation process and timing of proposed changes

1.2 A response document to the formal consultation would be published as part of the Autumn Statement (likely to be on "Legislation-Day"). The details of this remained subject to ministerial approval, but HMRC's current thinking was that in light of the points raised in the course of the consultation any changes to the "unallowable purpose" rule should be deferred to Finance Bill 2015. It was still expected that changes to the rules governing partnerships and bond funds would

be made in Finance Bill 2014, in line with the original timetable. Additionally it was expected that limited changes to the Disregard Regulations and the Change of Accounting Practice Regulations would be made using secondary legislation during the early part of 2014. Following further consideration on the issue, HMRC was now not currently looking to make changes to the taxation of index linked gilts.

1.3 It was HMRC's intention that the consultation response should include a response to the various issues discussed at the previous WG3 meeting relating to the timing and interaction with "new" UK GAAP of any changes to the loan relationships and derivative contracts regimes.

1.4 HMRC confirmed that there had been no change since the discussions in the previous WG3 meetings in their thinking in relation to perpetual debt.

Regulatory capital

1.5 HMRC noted that Regulations had been laid (SI 2013/2781) to extend the matching rules to hedges of the equity component of deferred shares (for building societies) or Additional Tier 1 instruments (for banks). These Regulations were expected to come into effect on 21 November 2013.

1.6 The final draft Regulations giving effect to the new regime for banks' regulatory capital more generally had yet to be published, but should be released shortly. It continued to be the intention that these would come into force on 1 January 2014. As it was intended that Additional Tier 1/Tier 2 instruments should be treated as held at amortised cost for tax purposes it was proposed that the final regulations would incorporate a further amendment to the Disregard Regulations to deal with the resulting problems where the instrument had been designated as fair value through profit and loss. This was in the context of elections made under regulation 6 of the Disregard Regulations, and would broadly replicate the approach taken to connected party debt where the same issues arose.

Macro hedging

1.7 HMRC had participated in separate discussions on macro hedging with a small number of large corporates which they found very productive. In light of these discussions, HMRC recognised that there were still unresolved issues in this area from an accountancy perspective would feed across to the tax treatment. While it appear that there were not many group affected, the amounts involved for those groups were significant. It was HMRC's view that the correct approach was therefore to develop the policy for hedge accounting with the circumstances of the general population in mind. It may be helpful to consider the companies affected by macro hedging as part of this, but equally it may be the case that they will warrant separate consideration.

2 Hedging

Background

2.1 HMRC agreed that companies should generally be able to carry out tax-effective hedging. The legislation that currently achieved this, however, was widely regarded as complex and difficult to understand. The consultation document had therefore been drafted on the basis that tax effective hedging could instead be

achieved in the majority of cases by following the accounting entries in the income statement, allowing for a substantial simplification of the legislation.

2.2 It was noted that whilst HMRC had seen examples of avoidance grounded in the existing rules (ie. regs 7, 8, 9, 9A and 10), they had not seen the widespread attempts at avoidance. This was in contrast to the drivers for change in other areas, particularly forex. Accordingly the driver for change in relation to the hedging rules was primarily, from HMRC's perspective, the desire for simplification, and the benefits which derive from this.

2.3 The condoc responses generally agreed that there was considerable scope for improving / simplification.

2.4 Notwithstanding the above, HMRC had recognised, given the responses received to the consultation document, that there were many taxpayers which highly valued the effect of the Disregard Regulations, especially in relation to undesignated hedges, and who had therefore express their concern of any potential abolition. It had been also noted that there was a small number of groups which, for technical reasons, were not expected to be able to hedge account under IFRS 9. There was also expected to be many groups who would potentially be able to hedge account but would not do so, either through choice or through a lack of awareness of the rules. It was also noted that it was likely to be a few more years before IFRS 9 becomes final and endorsed by the EU.

2.5 Accordingly HMRC could see that there was a case that some provision would need to be made for undesignated hedges, particularly in the short term. This could either be the Disregard Regulations (modified as appropriate) or new legislation performing a similar effect for undesignated hedges. HMRC's objective for the meeting was to gather views on how this should operate.

2.6 It was noted that HMRC wished to focus the discussion on hedges other than hedges of foreign exchange risk. In relation to the latter it continued to be HMRC's view that the right approach was, so far as possible, for the treatment of the hedge to mirror that of the hedged item – both in nature and amount. This approach was broadly welcomed, although it was noted that there were some cases where this would not be straightforward – for example, the hedge could relate to expenditure brought into account for both capital allowances and chargeable gains purposes, but should the hedge therefore be treated as a capital allowance adjustment or a chargeable gains adjustment?

Structure of legislation

2.7 HMRC were considering the possibility of much simpler principles-based legislation in place of the Disregard Regulations. There was some interest in this approach from the non-HMRC participants, as it was generally accepted that the Disregard Regulations were often regarded as difficult to understand and their precise effect in some cases could be ambiguous. This view was tempered however by a concern that at least part of the complexity in the current rules arose from the changes that had been made to cater for different scenarios as HMRC became aware of them; these rules were therefore at least "tried and tested" whereas any radical change in approach risked introducing additional problems/gaps into the regime.

2.8 Areas in which the existing rules did not always work well were discussed. Problems could arise in group situations if the hedge and hedged item were in different entities, but HMRC were reluctant to extend the rules to cover such cases as this was likely to be difficult to implement in practice.

2.9 HMRC also wished to identify areas where the hedged item was not taxed in line with the accounts and that simply following the accounts would not work even for designated hedges. One example given was of a hedge of interest rate risk in relation to preference shares.

Opt-in v Opt-out

2.10 A significant area of debate was whether any new regime for undesignated hedges should be opt-in (i.e. in the absence of an election tax would follow the accounts) or opt-out (i.e. in the absence of an election adjustments should be made to treat the hedge as tax-effective).

2.11 HMRC's preference was for an opt-in regime. This preference was motivated by the view that this was more consistent with the general approach in the derivative contracts regime of following the accounting treatment; i.e., that wherever possible the legislation should be drafted so as to make divergence from the accounting treatment an exception rather than the rule.

2.12 Many non-HMRC participants preferred an opt-out regime. This was primarily on the basis that the default position should be the one that minimised the tax volatility for both HMT and taxpayers.

2.13 It was noted that the concerns with an opt-in regime in part resulted from the need under the current regime for any election to be made up-front. There was a perception that a lack of familiarity with the regime, particularly among smaller groups, meant that it was not uncommon for this deadline to be missed simply because the availability was not considered until a much later stage. This made it important to ensure that the default position was the "safe" option, as was the current approach. If the way the elections operated could be revisited, however, then this would reduce the concerns with moving to an opt-in system as proposed by HMRC.

2.14 HMRC had a strong preference for an upfront election, as allowing a later deadline potentially allowed taxpayers to elect to take the benefit of losses whilst disregarding gains. This analysis was challenged by some of the non-HMRC participants, however, on the basis that the nature of the transactions in question meant that the risk should broadly only ever be one of timing. Moreover, even to the extent that a later deadline would allow taxpayers to choose the most favourable approach, this would typically only be in relation to one or two accounting periods (depending on what deadline was used). As the election was irrevocable then for subsequent periods the taxpayer would be exposed to the (potentially adverse) consequences of their choice in exactly the same way as at present. It was therefore unclear that in reality there would be any significant exposure to the exchequer from such an approach.

2.15 A further option would be to allow an election to be made at any time but with only prospective effect. This would avoid the concern raised by HMRC with regard to taxpayers potentially being able to benefit from the use of hindsight, whilst at the same time avoiding taxpayers being locked into a particular treatment through a lack of awareness.

Hedge ineffectiveness

2.16 The treatment of hedge ineffectiveness was a potentially difficult area. From a policy perspective it was not clear that any new rules should necessarily be drafted so as to automatically eliminate any tax volatility attributable to hedge

ineffectiveness. It was, however, felt to be important that from a policy perspective that the rules did not afford a more advantageous treatment to undesignated hedges than was available to designated hedges. In practice this meant that the approach to hedge ineffectiveness was closely linked to the question of how to define the scope of the rules governing undesignated hedges.

2.17 Many of the non-HMRC participants felt that the existing approach of focussing on the existence of a "hedging relationship" worked well. There was also a concern that attempting to more tightly define the scope so as to exclude hedge ineffectiveness would end up importing much of the complexity seen in the accounting rules. This result would both run contrary to the desire to avoid unduly complex legislation and mean that the rules would potentially exclude those companies which had undesignated hedges precisely because of the difficulties in complying with these accounting requirements.