

## Minutes of WG1 meeting on 31 October 2013

### Update on Finance Bill 2014

HMRC noted that they are currently putting together submissions for the Minister. There were originally four items on the list for inclusion in Finance Bill 2014 (FB 2014). The proposal now is not to include anything on index-linked gilts or unallowable purposes. The other two items are still on the list. With regard to partnerships, the legislation will be amended to make it clear that a corporate partner is deemed to be party to a proportionate amount of a loan relationship held by the partnership. With regard to bond funds, they are no longer intending to eliminate the rules entirely but rather to enhance the anti-avoidance protection around them and make some tweaks to the legislation to simplify the operation of the rules.

#### *Unallowable purposes*

There were six specific items in Consultation document.

- Netting of gains and losses on derivative contracts – the agreement following the last meeting was that a more targeted rule was appropriate. While it might be possible to draft this in time for FB 2014, it makes more sense to defer this and allow more time to develop a suitable rule.
- Chance of an advantage, definition of related transaction and group tax advantage – the intention had been to deal with these in FB 2014. However, there is a concern that these changes may have an impact elsewhere in tax code where similar language is used. By deferring these changes to 2015, it should be possible to ensure that the change do not have any adverse implications.
- Fungible pools of funding – it had already been agreed that this should probably be dealt with in a separate rule outside s441 Corporation Tax Act 2009 (CTA 2009), and this would be deferred until 2015.
- Unpicking composite amounts to identify amounts attributable to an unallowable purpose.

It had become clear that the latter two bullets were directly linked to the changes proposed in Chapter 4 of the consultation document *"Looking behind the accounts"*, and it was appropriate to consider all these together. Specific provisions may not be required if the issues could be addressed at a more fundamental level in the regime.

The general view from the group was that the proposals to defer the changes were sensible. It was noted that this would allow wider FB 2015 changes to be taken into account as well. This is important to ensure that the new s441 integrates properly into general structure.

It was reiterated that an unallowable purposes rule would still be needed under the new regime. The proposed regime TAAR is intended to focus only on avoidance within the loan relationships and derivative contracts regime while the unallowable purpose rules cover wider tax avoidance.

#### **"Fairly represents"**

HMRC explained that they want to understand more about the concerns raised at the last working group meeting. The fundamental concern seemed to be related to the suggestion in the consultation document that the new regime would include a non-specific rule to override accounts. The clear message from responses to the consultation was that this was not welcome due to unhelpful uncertainty. HMRC response to this concern was that the reason such a rule was proposed was not purely to counter avoidance. Rather, it was intended to ensure that the legislation would provide for the "right" answer for tax purposes despite, for instance, potential issues arising from the fact that loan relationships are a legal concept, not an accounting concept. The "fairly represents" rule can work in either direction, and has been invoked by taxpayers in the past. Following the last working group meeting, HMRC was going to reflect and consider whether they could add to the points made and positions taken at that meeting. HMRC noted that their position has not changed since that last meeting but they are happy to explore a way forward that doesn't involve a non-specific exception to following profit and loss in the accounts.

It was noted that, as discussed at the previous meeting, if the new regime does not include a general override that could work both ways, HMRC would still want to ensure adequate anti-avoidance protection for the regime, which would include the proposed regime TAAR. HMRC noted that the detail of this rule had not yet been considered in detail. However, it would of course provide an override to accounting treatment in appropriate circumstances. This was noted by HMRC as being particularly important given the general proposal to follow amounts recognised as profit or loss.

HMRC wasn't sure that the detailed mechanism of any anti-avoidance rule was relevant to the current discussion. The point is whether it is appropriate to retain the current flexibility potentially allowed under the "fairly represents" rule (ie. in cases where avoidance is not involved).

It was suggested that if there is no general override but there is an anti-avoidance rule, this might lead to debate and uncertainty similar to that around the application of the current unallowable purposes rule. HMRC noted that the clear direction of travel for anti-avoidance provisions is towards purposive tests. Consequently, their application is fact-dependent and a degree of uncertainty around application is unavoidable.

It was suggested by group members that there was then a question as to which uncertainty would be preferable. This might come down to whether the regime TAAR will be drafted differently whether or not there is a separate general override. If the TAAR would be the same in either case, this would suggest that eliminating the "fairly represents" would not create any additional uncertainty. One of the issues with "fairly represents" is that it is unfettered as there is no purpose test. The benefit of the regime TAAR is that if the taxpayer is satisfied that there is no avoidance purpose involved then this should provide some comfort that the accounts will be respected, subject to specific overrides, though of course full certainty will be impossible. In the context of arguments around "fairly represents", it can be difficult to define exactly what is meant by profit or loss. This may be easier in the context of an artificial scheme or arrangement which is seeking to avoid being taxed or to generate a loss. Therefore, the expectation is that a general purpose based TAAR will give more certainty. In this regard, it was noted that although the assumption is that the regime TAAR will be principles-based, it has not been decided whether the trigger will be a purpose test.

The general issue put forward by members of the working group is that it is difficult to look at these points in isolation. It is difficult to make any decision on "fairly represents" without seeing the regime TAAR. While it was agreed that "fairly represents" can operate in favour of the taxpayer, the feeling was that the situations that have been encountered in practice to date could be fixed by other means and indeed may not be an issue in new regime. HMRC reiterated that they are happy to explore a way forward without a non-specific override, but they may conclude that this is not possible and may need to reinstate the provision.

It was suggested that the new regime should include a power for HMRC to make provisions for any new specific overrides which may become appropriate to be dealt with in secondary legislation. HMRC noted that this may well be the case as it may be difficult to identify all situations where it may be necessary to depart from the accounts. It would also allow HMRC to respond to accounting changes.

In response to the point that it is important to consider the regime as a whole, HMRC noted that they are conscious of this and they have been working on a strawman of how the new regime might fit together. It was hoped to share this in the fairly near future. This should assist in seeing big picture.

### **Categorisation of departures from following profit and loss**

The consultation document (page 12) suggested that the new regime might seek to identify categories of departures from accounts. The thinking is that this would help with clarity, prevent manipulation and also, if necessary to include new rules, it might facilitate inserting the new rules into whole framework and thereby reduce the risk that new rules will degrade the coherence of the regime.

HMRC wanted to explore whether this approach could be helpful and if so whether it would be appropriate to have the relevant categorisations in legislation, guidance, etc. The responses to the consultation document were quite varied - some thought that this would be quite clumsy but others thought it would be very helpful and would increase certainty. The question for now is not whether

the categorisations are correct but whether the approach is sensible.

Some members of the group were not sure whether the categorisation approach would reflect what happens in practice. It might be helpful in guidance but some were not sure it would add much to the legislation. If there is no intention to change the impact of the individual rules, then arguably there would be little point in changing the layout. This was noted by HMRC, but one of aims of the consultation is to develop legislation which is clearer and easier to navigate, and this might assist.

Others thought that the categorisation could be helpful if done well. If there is a series of rules all seeking to do the similar things, then it may be helpful to group them together; this might assist with purposive interpretation. It was thought that it may be easier to discuss this once the legislative strawman is available.

Overall, there were no strong feelings on the categorisation approach.

It was noted that this might require a substantial rewrite. In this regard, HMRC confirmed that it had not yet been determined whether there will be a completely new code in FB 2015 or just amendments to the existing code. HMRC may prefer a new code but this doesn't necessarily mean a complete rewrite as some provisions are working as intended. HMRC asked the group for views on this. It was noted that if the loan relationships and derivative contracts codes are merged, it will be difficult to achieve this without starting from the beginning. The more fundamental the changes, the more it seems a new code will be required. Again, it would make sense to have this discussion once the strawman is available.

### **Looking behind the accounts**

The consultation document included the following proposal in Chapter 4:

*4.21. The central proposal is to make explicit that in certain circumstances tax should not be determined solely by reference to the amounts recognised in a company's financial statements, but instead on the amounts that would be brought into account in respect of loan relationships or derivative contracts if the accounting treatment were not influenced by or bound up with other instruments or transactions.*

HMRC noted that there had been a mixed response to this proposal. Some respondents thought that it was sensible. Others saw it as an extension of the uncertainty around "fairly represents" as it appeared to be another mechanism by which tax law would call for diversion from the accounts and the proposition in the consultation document was not very specific. However, overall the reaction was less negative and in some cases supportive when compared with the debate on "fairly represents".

The basic proposition is that the legislation would make it explicit that in certain circumstances, the accounts should be ignored and amounts should be brought into account on the basis of the accounting treatment which would have applied had the transaction in question not been bound up with or "interfered with" by other transactions or instruments. While it would still be addressing a general set of circumstance, the circumstances in which it would apply and the measure of the amount to be taxed would be set out at least in principle.

The working group agreed that there are clearly certain instances where departing from the income statement is the right approach, e.g. capitalised borrowing or avoidance based derecognition transactions. The question is whether there are just a few specific scenarios rather than so many that there is a need for a more general rule. The proposal, as outlined in the consultation document, is quite broad and so has potential for uncertainty. It is also not clear whether some of the examples given in the consultation document will actually arise in practice going forward if the starting point is amounts shown in profit and loss, and in light of the new accounting rules. It was agreed that the issues may be rarer than in the past.

It was suggested that some of the debate may be driven by different views on what the rule is designed to do. It was agreed that there is a need to have the ability to unpick and allocate amounts recorded in

the accounts correctly - between instruments, entities, periods, etc. However, the rule may not necessarily need to be as general as that proposed in paragraph 4.21 of the consultation document.

HMRC noted that the proposed change to the unallowable purposes rule regarding unpicking composite amounts was uncontroversial. It was suggested that this may have been because it was widely believed that unpicking composite amounts was already possible under the current wording of section 441 CTA 2009.

There was some agreement that there are circumstances where it might be appropriate to do something in the circumstances envisaged in Chapter 4 of the consultation document. However, there is still a question as to whether it is better to address these issues by a single generic rule or to try to identify the possible issues individually and deal with them separately. Some members appeared to feel that the examples in Chapter 4 would be better addressed by specific rules (some grouped together where possible) rather than a wider principle, though a general statement of purpose might assist with interpretation.

### **Next steps**

HMRC noted that the group has now had an initial discussion on most of issues scheduled for this group other than amalgamating the regimes and the regime TAAR. With regard to the outstanding issues, amalgamation is less about working out what the new regime is trying to achieve and to a lesser degree the same is true of the regime TAAR as the group will need to understand what the new regime looks like before the detail of any new TAAR can be considered.

The next step is to start looking at the new regime more holistically. The strawman should be helpful here and reviewing this should be a next step.

As regards timetable, it was noted that a number of additional meetings had been scheduled on the basis that the group would be reviewing draft legislation. However, as the unallowable purposes changes have now been deferred, it was decided to cut out a couple of meeting to leave it at one for November and one for December. HMRC is aiming to share the strawman for discussion at one or other of the remaining 2013 meetings.

Once Autumn Statement has been delivered, HMRC will want to start planning the larger timetable for 2014 - how the consultation will run and timing for delivery of instructions to Parliamentary Counsel, etc.