

**Modernising the taxation of corporate debt and derivative contracts**  
**Minutes of Working Group 3 meeting on 21 May 2014**  
**100 Parliament Street 11.00 to 13:00**

**Attendees:**

Andrei Belinski (Centrica)  
Chris Kell (HSBC)  
David Boneham (Deloitte / CIOT)  
David Hill (Grant Thornton)  
David Stainer (Allen & Overy)  
Fiona Thomson (E&Y)  
John Lindsay (Linklaters)  
Matthew Hodkin (Norton Rose)  
Neil Edwards (PwC)  
Paul Freeman (KPMG)

Andy Stewardson (HMRC)  
Richard Daniel (HMRC)  
Oli Jones (HMRC)  
Roger Muray (HMRC)  
Robert Harvey (HMRC)

Apologies:

Anne Murphy (L&G / ABI)  
Jackie Latham (Rolls Royce)  
Kieran Sweeney (Lloyds Banking Group)

**1 Introduction**

*Meetings*

- 1.1 Apologies were given for the late cancellation of the previous meeting. HMRC would give thought to the best way of structuring meetings going forward (particularly in relation to frequency and timing) to ensure that they were useful for all participants.

*Status update*

- 1.2 HMRC provided a brief status update in relation to the various topics within the remit of WG3.
- 1.3 Disregard/COAP Regulations: It was intended to publish draft legislation over the summer with a view to this being force by the end of 2014. HMRC hoped to be in a position to circulate an initial draft within WG3 in the course of June.

- 1.4 Following profit and loss: It was noted that there were links into the WG1 discussions on the role of the accounts. It was therefore going to be necessary for both groups to review draft legislation, etc.
- 1.5 Fair value hedging of connected party debt: This similarly linked into the general discussions on the treatment of connected part debt in WG2. Again a joined up approach would be required.
- 1.6 Hedging: HMRC hoped to smooth the interface between the primary and secondary legislation. For example, there was an argument to move the modification to the group continuity rules currently in secondary legislation [Reg 6(11) – (13) of Disregard Regulations] to primary legislation, where the group continuity rules themselves were set out.
- 1.7 Forex: There should be some ‘tidying up’ of primary and secondary legislation. Some changes would also be required to reflect the move to “following profit and loss”. It was currently thought that there may be scope to repeal the one-way effect anti-avoidance provisions, and that instead such schemes would be covered by the regime-TAAR.
- 1.8 Hybrids: It was noted that some of the proposals might be put into effect using secondary rather primary legislation. The powers to do this already existed and such an approach had the potential to ease the pressure on the Finance Bill process, although the importance of ensuring adequate scrutiny for any draft legislation was recognised.
- 1.9 Derivatives: HMRC confirmed that it was intended to make some changes to the detail of the definition of “relevant contract”, although no fundamental changes were being proposed. HMRC would be looking at the operation of the accounting test and noted concerns raised by the other WG3 participants around the aspects of the test based on the underlying subject matter, particularly commodities. Concerns were also noted in relation to the disregard of the accounting requirements in respect of the initial net investment; this arguably meant that any financial asset or liability fell within the derivative contract rules. These aspects of the accounting test could be an unwelcome source of uncertainty for commercial transactions. The rules had been drafted in this way so as to limit the scope for companies to manipulate arrangements in or out of the derivative contracts regime. Although it was accepted that the specific arrangements which the rules had originally been targeting were now likely to be caught by separate anti-avoidance provisions, HMRC continued to have a concern that very similar instruments could have very different treatment dependent on the amount paid upfront to enter into the contract.

## 2 Equity instruments

### *Background*

- 2.1 As previously noted it was proposed to move to an approach in which, with limited exceptions, only amounts recognised in profit and loss would be brought into account under the loan relationship regime. Amounts taken directly to equity would in most cases be disregarded. This proposal had raised a number of questions about the treatment of loan relationships that for accounting purposes fell to be treated as equity instruments. *Prima facie* the proposed change would mean that, in particular, relief ceased to be available for any coupon paid on such instruments.
- 2.2 HMRC’s view was that in considering the position of such instruments they should be split into broadly three categories:

- Instruments dealt with under the Taxation of Regulatory Capital Securities Regulations 2013 [SI 2013/3209];
- Regulatory Capital Securities not dealt with under these regulations; and
- other loan relationships accounted for as equity instruments.

*Regulatory Capital Securities within SI 2013/3209*

- 2.3 One of the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 was to ensure that in most cases relief should be available for coupon payments on debt instruments which formed part of a bank's Additional Tier 1 or Tier 2 capital.
- 2.4 HMRC confirmed that there had been no change of policy in this regard.
- 2.5 Concerns had been raised, however, that the Regulations in their current form would not be effective to ensure that relief would continue to be available after the move to just following profit and loss. HMRC therefore proposed to revisit the Regulations in due course in order to ensure that they would continue to operate properly.

*Regulatory Capital Securities not within SI 2013/3209*

- 2.6 Not all existing Regulatory Capital Securities issued by financial institutions fell within the scope of SI 2013/3209. HMRC acknowledged that to the extent such instruments had historically attracted tax relief on coupon payments there was an argument that some form of transitional provision should be put in place. Whilst there was an expectation that many instruments would contain provision for their redemption on adverse change in their tax profile (such as was expected to be caused by the proposal to disregard amounts recognised directly in equity), there were clear risks in adopting a course of action which might trigger a widespread redemption of regulatory capital.
- 2.7 One possibility would be to "grandfather" existing instruments. The concern with such an approach would be its potentially long impact, as in the interests of reducing complexity there was a general desire to minimise the number and duration of any exceptions to the basic approach being adopted. It was noted, however, that the regulatory capital benefit of such instruments would be eroded over time such that the reliance on any grandfathering provisions would be expected to naturally reduce. One option would be 'switch off' these provisions in 2022, in line with the transitional provisions providing the regulatory capital benefit.

*Other equity instruments*

- 2.8 In relation to other equity instruments the question was whether to provide a similar transitional provision so as to ensure relief continued to be available, at least for some period of time. HMRC was currently reluctant to recommend such a provision, given the desire to reduce complexity already noted and HMRC's perception that the policy arguments in favour of a transitional provision were weaker for equity instruments generally than for regulatory capital securities.
- 2.9 It was noted that this created a theoretical risk of asymmetric tax treatment: the issuer of the equity instrument would not obtain relief for coupon payments, but the holder would usually be taxed on the corresponding receipts. The proposal to

exclude new “perpetual” instruments from the loan relationship regime could give rise to similar problems even if a transitional provision for existing equity instruments was put in place.

- 2.10 HMRC, whilst acknowledging the existence of a theoretical mismatch, questioned whether this was in fact a real problem. Were there a significant number of taxpayers undertaking commercial transactions which would be impacted by this and unable to simply structure around the issue? HMRC would nonetheless give some thought to what options existed to mitigate the impact of the changes. One possibility in relation to the rules excluding new perpetuals could be to not simply deem these not to be money debts, but to instead deem them to be something different entirely so as to give a symmetrical tax treatment.
- 2.11 Other issues noted as needing further consideration in relation to equity instruments and perpetual were the capital gains aspects (e.g. should such instruments be deemed to be QCBs?) and forex.

### 3 Foreign exchange rules

#### *Functional currency*

- 3.1 Certain aspects of the functional currency rules had been identified which were felt to be unclear and/or failed to clearly operate in line with the underlying policy objectives. Examples included:
- A US incorporated company prepares its accounts under US GAAP in USD, but if it applied UK GAAP it would have a different functional currency, EUR say. What functional currency should it use for tax purposes?
  - Questions over the relative priority of the functional currency rules within CTA 2010 and the loan relationship regime.
  - The application of a designated currency election to a company with overseas operations; for example a UK investment company acting as partner in an overseas partnership with a different functional currency.
- 3.2 HMRC were interested in what steps could be taken to address these and any other problem areas which might be identified around the functional currency rules.

#### *Changes in functional currency*

- 3.3 One aspect of the rules which had attracted attention was the disregard of exchange gains and losses of investment companies in the 12 months following a change in functional currency [s328(2A) CTA 2009]. The rule existed to prevent companies being able to use hindsight to ‘flip’ functional currency so as to generate losses, but had the potential to also apply in cases where there was no choice in the change of functional currency (e.g. a change resulting from the acquisition by a company with different functional currency). Exclusion of exchange gains and losses in cases where there was an actual change in the underlying facts, rather than merely a change in accounting, was not the policy intention and could disadvantage taxpayers or HMRC. HMRC noted, however, that it could be difficult to distinguish between the different cases, and that the provision could equally be seen as protecting both taxpayers and HMRC. HMRC continued to see this as a significant risk area which would not be fully addressed by the regime-TAAR.

- 3.4 It was also noted that the application of the rule could be unclear in some cases – for example, in relation to a company moving from a GBP to USD functional currency but party to EUR denominated loan relationships. Potentially this could be addressed by guidance.

*Disposal of foreign operations*

- 3.5 It had been identified that under IFRS there was the possibility of amounts being recycled to the income statement on a disposal of foreign operations; for example, the foreign exchange gains and losses relating to a net investment hedge. HMRC was not seeking to disturb the existing approach of effectively disregarding such amounts and was therefore considering a specific rule to address this.

*Hedges of investments held through partnerships*

- 3.6 If a corporate partner entered into a hedge of foreign exchange gains and losses arising on shares held by the partnership then it was unclear whether the Disregard Regulations would apply. After transition to “new” UK GAAP SSAP 20 hedging would no longer apply and there would then be a period of time before the proposed changes to the partnership rules would come into effect. During this period it was unclear that the hedge would be effective for tax purposes. HMRC was aware of this issue and was in the process of considering what options existed to fix it.

*Secondary legislation*

- 3.7 HMRC hoped to refresh the foreign exchange aspects of the key secondary legislation. The general aim continued to be that foreign exchange gains and losses arising on a hedging instrument should be brought into tax on the same basis (i.e. same timing and characterisation) as the corresponding gains and losses on the hedged item.